

POWER INTEGRATIONS INC

FORM 10-Q (Quarterly Report)

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, DC 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the quarterly period ended September 30, 2012

or

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from _____ to _____

Commission File Number 0-23441

POWER INTEGRATIONS, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction of
Incorporation or organization)

94-3065014
(I.R.S. Employer
Identification No.)

5245 Hellyer Avenue, San Jose, California, 95138

(Address of principal executive offices) (Zip code)

(408) 414-9200

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by check mark whether the registrant submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

<u>Class</u>	<u>Shares Outstanding at October 19, 2012</u>
Common Stock, \$.001 par value	28,969,549

POWER INTEGRATIONS, INC.

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Cautionary Note Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q includes a number of forward-looking statements that involve many risks and uncertainties. Forward-looking statements are identified by the use of the words “would”, “could”, “will”, “may”, “expect”, “believe”, “should”, “anticipate”, “outlook”, “if”, “future”, “intend”, “plan”, “estimate”, “predict”, “potential”, “targets”, “seek” or “continue” and similar words and phrases, including the negatives of these terms, or other variations of these terms, that denote future events. These statements reflect our current views with respect to future events and our potential financial performance and are subject to risks and uncertainties that could cause our actual results and financial position to differ materially and adversely from what is projected or implied in any forward-looking statements included in this Form 10-Q. These factors include, but are not limited to, the risks described under Item 1A of Part II — “Risk Factors,” Item 2 of Part I — “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this Quarterly Report on Form 10-Q, including: our quarterly operating results are volatile and difficult to predict, and if we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly; intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and reduced sales volume of our products; if demand for our products declines in our major end markets, our net revenues will decrease; if we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability; if we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies; and our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. We make these forward-looking statements based upon information available on the date of this Form 10-Q, and we have no obligation (and expressly disclaim any obligation) to update or alter any forward-looking statements, whether as a result of new information or otherwise except as otherwise required by securities regulations.

PART I. FINANCIAL INFORMATION
 ITEM 1. FINANCIAL STATEMENTS

POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
 (unaudited)
 (In thousands)

	<u>September 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 74,747	\$ 139,836
Short-term marketable securities	35,605	40,899
Accounts receivable, net of allowances of \$292 and \$215 in 2012 and 2011, respectively (Note 2)	11,106	9,396
Inventories	46,928	52,010
Deferred tax assets	892	892
Prepaid expenses and other current assets	17,659	7,068
Total current assets	<u>186,937</u>	<u>250,101</u>
LONG-TERM MARKETABLE SECURITIES	—	32,041
PROPERTY AND EQUIPMENT, net	90,355	88,241
INTANGIBLE ASSETS, net	49,580	8,852
GOODWILL	78,278	14,786
DEFERRED TAX ASSETS	7,410	12,387
OTHER ASSETS	4,042	26,511
Total assets	<u>\$ 416,602</u>	<u>\$ 432,919</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 19,697	\$ 16,532
Accrued payroll and related expenses	6,258	5,911
Taxes payable	1,168	—
Deferred tax liabilities	1,634	—
Deferred income on sales to distributors	10,437	7,883
Other accrued liabilities	17,583	2,305
Total current liabilities	<u>56,777</u>	<u>32,631</u>
LONG-TERM INCOME TAXES PAYABLE	7,560	34,368
DEFERRED TAX LIABILITIES	3,926	—
PENSION LIABILITY	663	—
Total liabilities	<u>68,926</u>	<u>66,999</u>
COMMITMENTS AND CONTINGENCIES (Notes 9, 11 and 12)		
STOCKHOLDERS' EQUITY:		
Common stock	29	28
Additional paid-in capital	188,587	158,646
Accumulated other comprehensive income	287	50
Retained earnings	158,773	207,196
Total stockholders' equity	<u>347,676</u>	<u>365,920</u>
Total liabilities and stockholders' equity	<u>\$ 416,602</u>	<u>\$ 432,919</u>

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME (LOSS)
(unaudited)
(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
NET REVENUES	\$ 78,045	\$ 75,063	\$ 226,200	\$ 232,009
COST OF REVENUES	39,294	40,020	115,101	122,917
GROSS PROFIT	38,751	35,043	111,099	109,092
OPERATING EXPENSES:				
Research and development	11,428	10,345	34,134	30,563
Sales and marketing	10,329	7,990	27,643	24,342
General and administrative	7,941	6,145	22,135	18,761
Charge related to SemiSouth (Note 15)	25,300	—	25,300	—
Total operating expenses	54,998	24,480	109,212	73,666
INCOME (LOSS) FROM OPERATIONS	(16,247)	10,563	1,887	35,426
OTHER INCOME (EXPENSE)				
Charge related to SemiSouth (Note 15)	(33,937)	—	(33,937)	—
Other income, net	837	552	1,647	1,455
Total other income (expense)	(33,100)	552	(32,290)	1,455
INCOME (LOSS) BEFORE PROVISION (BENEFIT) FOR INCOME TAXES	(49,347)	11,115	(30,403)	36,881
PROVISION (BENEFIT) FOR INCOME TAXES	(4,941)	3,603	13,718	8,916
NET INCOME (LOSS)	\$ (44,406)	\$ 7,512	\$ (44,121)	\$ 27,965
EARNINGS (LOSS) PER SHARE:				
Basic	\$ (1.54)	\$ 0.26	\$ (1.54)	\$ 0.97
Diluted	\$ (1.54)	\$ 0.25	\$ (1.54)	\$ 0.93
SHARES USED IN PER SHARE CALCULATION:				
Basic	28,908	28,799	28,586	28,789
Diluted	28,908	29,879	28,586	30,195

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(unaudited)
(In thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net income (loss)	\$ (44,406)	\$ 7,512	\$ (44,121)	\$ 27,965
Other comprehensive income (loss), net of tax:				
Foreign currency translation adjustments	114	(78)	47	(5)
Unrealized gain on marketable securities	28	—	190	—
Total other comprehensive income (loss)	142	(78)	237	(5)
Total comprehensive income (loss)	<u>\$ (44,264)</u>	<u>\$ 7,434</u>	<u>\$ (43,884)</u>	<u>\$ 27,960</u>

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

POWER INTEGRATIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ (44,121)	\$ 27,965
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	11,426	11,337
Amortization of intangibles	3,322	729
Charge related to SemiSouth (Note 15)	59,237	—
Gain on sale of property and equipment	(1)	(41)
Stock-based compensation expense	10,520	6,617
Amortization of premium on marketable securities	738	1,255
Non-cash interest income from SemiSouth note	(1,445)	—
Deferred income taxes	4,089	779
Provision for (reduction in) accounts receivable allowances	21	(74)
Excess tax benefit from stock options exercised	(560)	(729)
Tax benefit associated with employee stock plans	1,413	1,826
Change in operating assets and liabilities:		
Accounts receivable	1,489	(4,542)
Inventories	15,745	10,184
Prepaid expenses and other assets	(11,335)	2,823
Accounts payable	4,842	(1,090)
Taxes payable and accrued liabilities	(28,255)	4,891
Deferred income on sales to distributors	2,554	(1,904)
Net cash provided by operating activities	<u>29,679</u>	<u>60,026</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(12,181)	(16,229)
Proceeds from sale of property and equipment	2	2,249
Acquisitions	(115,720)	(6,914)
Other assets	—	(1,271)
Increase in financing lease receivable	(420)	(7,978)
Collections of financing lease receivable	527	314
Loan to SemiSouth	(18,000)	(3,000)
Collection of note to SemiSouth	—	3,000
Purchases of marketable securities	—	(31,269)
Proceeds from maturities of marketable securities	36,788	15,175
Net cash used in investing activities	<u>(109,004)</u>	<u>(45,923)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock under employee stock plans	17,977	18,218
Repurchase of common stock	—	(35,819)
Payments of dividends to stockholders	(4,301)	(4,320)

	Nine Months Ended September 30,	
Excess tax benefit from stock options exercised	560	729
Net cash provided by (used in) financing activities	14,236	(21,192)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(65,089)	(7,089)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	139,836	155,667
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 74,747	\$ 148,578
SUPPLEMENTAL DISCLOSURE OF NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Unpaid property and equipment	\$ 1,478	\$ 3,486
Receipt of SemiSouth purchase option	\$ 6,216	\$ —
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for income taxes, net of refunds	\$ 45,108	\$ 553

The accompanying notes are an integral part of these unaudited condensed consolidated financial statements.

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION:

The condensed consolidated financial statements include the accounts of Power Integrations, Inc., a Delaware corporation (the “Company”), and its wholly owned subsidiaries. Significant intercompany accounts and transactions have been eliminated in consolidation.

While the financial information furnished is unaudited, the condensed consolidated financial statements included in this report reflect all adjustments (consisting only of normal recurring adjustments) that the Company considers necessary for the fair presentation of the results of operations for the interim periods covered and the financial condition of the Company at the date of the interim balance sheet in accordance with accounting principles generally accepted in the United States of America (“U.S. GAAP”). The results for interim periods are not necessarily indicative of the results for the entire year. The condensed consolidated financial statements should be read in conjunction with the Power Integrations, Inc. consolidated financial statements and the notes thereto for the year ended December 31, 2011 , included in its Form 10-K filed on February 29, 2012 , with the Securities and Exchange Commission.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

No material changes have been made to the Company's significant accounting policies disclosed in Note 2, *Summary of Significant Accounting Policies* , in its Annual Report on Form 10-K, filed on February 29, 2012 , for the year ended December 31, 2011 , except for the changes discussed below. The accounting policy information below is to aid in the understanding of the financial information disclosed.

Cash and Cash Equivalents

The Company considers cash invested in highly liquid financial instruments with maturities of three months or less at the date of purchase to be cash equivalents.

Marketable Securities

In the first quarter of 2012, the Company changed its investment policy to permit the sale of long-term and short-term marketable securities prior to their stated maturity date. The Company generally holds securities until maturity; however, they may now be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments. As a result of this change in policy the Company classifies its investment portfolio as available-for-sale as opposed to held-to-maturity beginning March 31, 2012. Prior to March 31, 2012, the Company classified its investments as held-to-maturity. In connection with this change in investment policy the Company classified all investments with an original maturity date greater than three months as short-term investments in its Condensed Consolidated Balance Sheet. The Company's short-term investment portfolio is invested in highly liquid financial instruments with maturities greater than three months. As of September 30, 2012 , and December 31, 2011 , the Company's marketable securities consisted of U.S. government-backed securities, municipal bonds, corporate commercial paper, certificates of deposit and other high-quality commercial securities.

Amortized cost and estimated fair market value of investments classified as available-for-sale at September 30, 2012 , are as follows (in thousands):

POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	\$ 12,922	\$ —	\$ —	\$ 12,922
Corporate securities	3,682	5	—	3,687
Total	\$ 16,604	\$ 5	\$ —	\$ 16,609
Investments due in 4-12 months:				
Corporate securities	\$ 25,732	\$ 129	\$ —	\$ 25,861
Total	\$ 25,732	\$ 129	\$ —	\$ 25,861
Investments due in more than 12 months:				
Corporate securities	\$ 6,000	\$ 57	\$ —	\$ 6,057
Total	\$ 6,000	\$ 57	\$ —	\$ 6,057
Total investment securities	\$ 48,336	\$ 191	\$ —	\$ 48,527

Amortized cost and estimated fair market value of investments classified as held-to-maturity at December 31, 2011, are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Losses	Estimated Fair Market Value
Investments due in less than 3 months:				
Commercial paper	\$ 9,849	\$ —	\$ —	\$ 9,849
Corporate securities	6,098	9	(1)	6,106
Total	\$ 15,947	\$ 9	\$ (1)	\$ 15,955
Investments due in 4-12 months:				
Corporate securities	\$ 24,801	\$ 179	\$ (23)	\$ 24,957
Certificates of deposit	10,000	1	—	10,001
Total	\$ 34,801	\$ 180	\$ (23)	\$ 34,958
Investments due in more than 12 months:				
Corporate securities	\$ 32,041	\$ 5	\$ (178)	\$ 31,868
Total	\$ 32,041	\$ 5	\$ (178)	\$ 31,868
Total investment securities	\$ 82,789	\$ 194	\$ (202)	\$ 82,781

As of September 30, 2012, the Company had no marketable securities in an unrealized loss position. The Company evaluated the nature of the investments with a loss position at December 31, 2011, which were primarily high-quality commercial securities, and determined the unrealized losses were not other-than-temporary.

Revenue Recognition

Product revenues consist of sales to original equipment manufacturers (“OEMs”), merchant power supply manufacturers and distributors. Approximately 74% of the Company's net product sales were made to distributors in the nine months ended September 30, 2012, and 71% in the twelve months ended December 31, 2011. The Company applies the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to the Company's customer. The Company evaluates whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

respect to collectability, the Company performs credit checks for new customers and performs ongoing evaluations of its existing customers' financial condition and requires letters of credit whenever deemed necessary.

Sales to international OEM customers and merchant power supply manufacturers that are shipped from the Company's facility in California are pursuant to "delivered at frontier" ("DAF") shipping terms. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of the product in that country. Sales to international OEMs and merchant power supply manufacturers for shipments from the Company's facility outside of the United States are pursuant to "EX Works" ("EXW") shipping terms, meaning that title to the product transfers to the customer upon shipment from the Company's foreign warehouse. Shipments to OEMs and merchant power supply manufacturers in the Americas are pursuant to "free on board" ("FOB") point of origin shipping terms meaning that title is passed to the customer upon shipment. Revenue is recognized upon title transfer for sales to OEMs and merchant power supply manufacturers, assuming all other criteria for revenue recognition are met.

Sales to most of the Company's distributors are made under terms allowing certain price adjustments and rights of return on the Company's products held by its distributors. As a result of these rights, the Company defers the recognition of revenue and the costs of revenues derived from sales to distributors until the Company's distributors report that they have sold the Company's products to their customers. The Company's recognition of such distributor revenue is based on point of sale reports received from the distributors, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to the Company except pursuant to warranty terms. The gross profit that is deferred as a result of this policy is reflected as "deferred income on sales to distributors" in the accompanying condensed consolidated balance sheets. The total deferred revenue as of September 30, 2012, and December 31, 2011, was approximately \$20.8 million and \$16.7 million, respectively. The total deferred cost as of September 30, 2012, and December 31, 2011, was approximately \$10.4 million and \$8.8 million, respectively.

Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At or soon after the distributor invoices its customer, the distributor submits a "ship and debit" price adjustment claim to the Company to adjust the distributor's cost from the standard price to the pre-approved lower price. After verification by the Company, a credit memo is issued to the distributor for the ship and debit claim. The Company maintains a reserve for unprocessed claims and future ship and debit price adjustments. The reserve appears as a reduction to accounts receivable in the Company's accompanying consolidated balance sheets. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on the deferred revenue and deferred margin ultimately recognized. To evaluate the adequacy of its reserves, the Company analyzes historical ship and debit payments and levels of inventory in the distributor channels.

Sales to certain distributors of the Company are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, product revenue is recognized upon shipment and title transfer assuming all other revenue recognition criteria are met.

Common Stock Repurchases and Cash Dividend

In February 2011, the board of directors authorized the use of \$50.0 million for the repurchase of the Company's common stock. In the twelve months ended December 31, 2011, the Company repurchased 1.5 million shares for a total of \$50.0 million, concluding this repurchase program. In November 2011, the board of directors authorized the use of an additional \$30.0 million for the repurchase of the Company's common stock, and in March 2012, the Company canceled its \$30.0 million stock repurchase program in connection with its purchase agreement to acquire CT-Concept Technologie AG. In October 2012, the Company's board of directors authorized the use of an additional \$50 million for the repurchase of our common stock. Repurchases are to be executed according to pre-defined price/volume guidelines set by the board of directors. Authorization of future stock repurchase programs is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions as well as other factors.

In October 2010, the Company's board of directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2011. The first quarterly dividend payment of approximately \$1.4 million was made on March 31, 2011, the second quarterly dividend payment of \$1.4 million was made on June 30, 2011, the third quarterly dividend payment of \$1.4 million was made on September 30, 2011, and the final 2011 quarterly dividend payment of \$1.4 million was made on December 30, 2011. In January 2012, the Company's board of

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

directors declared four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2012. The first quarterly dividend payment of approximately \$1.4 million was made on March 30, 2012, the second quarterly dividend payment of \$1.4 million was paid on June 29, 2012, and the third quarterly dividend payment of \$1.4 million was made on September 28, 2012, with the final quarterly dividend payment to be approximately the same amount. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of the Company's stockholders.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company evaluates its estimates, including those related to revenue recognition, income tax, stock-based compensation and inventories. These estimates are based on historical facts and various other assumptions that the Company believes to be reasonable at the time the estimates are made.

Components of the Company's Condensed Consolidated Balance Sheet

Accounts Receivable (in thousands):

	September 30, 2012	December 31, 2011
Accounts receivable trade	\$ 39,125	\$ 27,972
Accrued ship and debit and rebate claims	(27,727)	(18,361)
Allowance for doubtful accounts	(292)	(215)
Total	<u>\$ 11,106</u>	<u>\$ 9,396</u>

Prepaid Expenses and Other Current Assets (in thousands):

	September 30, 2012	December 31, 2011
Prepaid legal fees	\$ 875	\$ 3,500
Prepaid income tax	12,708	118
Prepaid maintenance agreements	677	669
Interest receivable	325	625
Supplier prepayment	1,100	—
Other	1,974	2,156
Total	<u>\$ 17,659</u>	<u>\$ 7,068</u>

Other Assets (in thousands):

	September 30, 2012	December 31, 2011
Prepaid royalty - SemiSouth (Note 15)	\$ —	\$ 10,000
SemiSouth related assets (Note 15)	—	7,000
Financing lease receivables and deposits - SemiSouth (Note 15)	—	7,558
Other	4,042	1,953
Total	<u>\$ 4,042</u>	<u>\$ 26,511</u>

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. STOCK PLANS AND SHARE-BASED COMPENSATION:

Stock Plans

As of September 30, 2012, the Company had two stock-based compensation plans (the "Plans") which are described below.

2007 Equity Incentive Plan

The 2007 Equity Incentive Plan (the "2007 Plan") was adopted by the board of directors on September 10, 2007 and approved by the stockholders on November 7, 2007, as an amendment and restatement of the 1997 Stock Option Plan (the "1997 Plan"). The 2007 Plan provides for the grant of incentive stock options, nonstatutory stock options, restricted stock awards, restricted stock unit awards ("RSUs"), stock appreciation rights, performance stock awards and other stock awards to employees, directors and consultants. In June 2012, the Company's stockholders approved the 2007 Equity Incentive Plan, as amended to increase the aggregate number of shares of the Company's common stock authorized for issuance under the plan by 2,800,000 shares. As of September 30, 2012, the maximum remaining number of shares that may be issued under the 2007 Plan was 8,679,502 shares, which includes options granted but not exercised and awards granted but unvested and shares remaining available for issuance under the 1997 Plan, including shares subject to outstanding options and stock awards under the 1997 Plan. Pursuant to the 2007 Plan, the exercise price for incentive stock options and nonstatutory stock options is generally at least 100% of the fair market value of the underlying shares on the date of grant. Options generally vest over 48 months measured from the date of grant. Options generally expire no later than ten years after the date of grant, subject to earlier termination upon an optionee's cessation of employment or service.

Beginning January 27, 2009, grants pursuant to the Directors Equity Compensation Program (that was adopted by the board of directors on January 27, 2009) to nonemployee directors have been made primarily under the 2007 Plan. The Directors Equity Compensation Program, until June 2012, provided in certain circumstances (depending on the status of the particular director's holdings of Company stock options) for the automatic annual grant of nonstatutory stock options to nonemployee directors of the Company on the first trading day of July in each year over their period of service on the board of directors. Further, each future nonemployee director of the Company would be granted the following initial grants under the 2007 Plan: (a) on the first trading day of the month following commencement of service, an option to purchase the number of shares of common stock equal to: the fraction of a year between the date of the director's appointment to the board of directors and the next July 1, multiplied by 8,000, which option shall vest on the next July 1st; and (b) on the first trading day of July following commencement of service, an option to purchase 24,000 shares vesting monthly over the three year period commencing on the grant date. In July 2012, this program was amended by eliminating the grants described above in their entirety, and providing for grants to outside directors as follows: effective annually, upon the first trading day of July, each outside director would receive a grant of an equity award with an aggregate value of \$100,000. At each outside directors election, such award would consist entirely of RSUs or entirely of stock options. The quantity of options would be calculated by dividing \$100,000 by the Black-Scholes value on the date of grant. The quantity of RSUs issued would be calculated by dividing \$100,000 by the grant date fair value. Further, on the date of election of a new outside director, such new director would receive such grant as continuing outside directors receive on the first trading day of July; provided, however, that such grant is prorated for the portion of the year that such new outside director will serve until the next first trading day of July. The Directors Equity Compensation Program will remain in effect at the discretion of the board of directors or the compensation committee.

On July 28, 2009, the 2007 Plan was amended generally to prohibit outstanding options or stock appreciation rights from being cancelled in exchange for cash without stockholder approval.

1997 Employee Stock Purchase Plan

Under the 1997 Employee Stock Purchase Plan (the "Purchase Plan"), eligible employees may apply accumulated payroll deductions, which may not exceed 15% of an employee's compensation, to the purchase of shares of the Company's common stock at periodic intervals. The purchase price of stock under the Purchase Plan is equal to 85% of the lower of (i) the fair market value of the Company's common stock on the first day of each offering period, or (ii) the fair market value of the Company's common stock on the purchase date (as defined in the Purchase Plan). Each offering period consists of one purchase period of approximately six months duration. An aggregate of 3,000,000 shares of common stock were reserved for issuance to employees under the Purchase Plan. As of September 30, 2012, 2,470,690 shares had been purchased and 529,310

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

shares were reserved for future issuance under the Purchase Plan.

Stock-Based Compensation

The Company applies the provisions of ASC 718-10. Under the provisions of ASC 718-10, the Company recognizes the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. The Company uses estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation expense to recognize. The Company uses the straight-line method to amortize all stock awards granted over the requisite service period of the award.

Determining Fair Value of Stock Options

The Company uses the Black-Scholes valuation model for valuing stock option grants using the following assumptions and estimates:

Expected Volatility . The Company calculates expected volatility based on the historical price volatility of the Company's stock.

Expected Term . The Company utilizes a model which uses historical exercise, cancellation and outstanding option data to calculate the expected term of stock option grants.

Risk-Free Interest Rate . The Company bases the risk-free interest rate used in the Black-Scholes valuation model on the implied yield available on a U.S. Treasury note with a term approximately equal to the expected term of the underlying grants.

Dividend Yield . The dividend yield was calculated by dividing the annual dividend by the average closing price of the Company's common stock on a quarterly basis.

Estimated Forfeitures . The Company uses historical data to estimate pre-vesting forfeitures, and records share-based compensation expense only for those awards that are expected to vest.

The following table summarizes the stock-based compensation expense recognized in accordance with ASC 718-10 for the three and nine months ended September 30, 2012 , and September 30, 2011 (in thousands).

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Cost of revenues	\$ 271	\$ 128	\$ 772	\$ 584
Research and development	1,467	564	4,154	2,354
Sales and marketing	940	449	2,433	1,659
General and administrative	1,169	527	3,161	2,020
Total stock-based compensation expense	<u>\$ 3,847</u>	<u>\$ 1,668</u>	<u>\$ 10,520</u>	<u>\$ 6,617</u>

The following table summarizes total compensation expense related to unvested awards not yet recognized, net of expected forfeitures, and the weighted average period over which it is expected to be recognized as of September 30, 2012 .

POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	September 30, 2012	
	Unrecognized Compensation Expense for Unvested Awards	Weighted Average Remaining Recognition Period
	(In thousands)	(In years)
Options	\$ 4,500	2.01
Performance-based awards	700	0.25
Restricted stock units	17,100	2.67
Purchase plan	400	0.50
Total unrecognized compensation expense	<u>\$ 22,700</u>	

Stock compensation expense in the three and nine months ended September 30, 2012, was \$3.8 million (comprising approximately \$1.1 million related to stock options, \$0.4 million related to performance shares, \$2.0 million related to restricted stock units and \$0.3 million related to the Purchase Plan) and \$10.5 million (comprising approximately \$3.0 million related to stock options, \$1.6 million related to performance shares, \$5.1 million related to restricted stock units and \$0.8 million related to the Purchase Plan), respectively.

Stock compensation expense in the three and nine months ended September 30, 2011, was \$1.7 million (comprising approximately \$1.0 million related to stock options, a reduction of \$0.7 million related to performance shares that were not expected to vest (see the performance-based awards section below for details), \$1.1 million related to restricted stock units and \$0.3 million related to the Purchase Plan), and \$6.6 million (comprising approximately \$3.1 million related to stock options, \$2.5 million related to restricted stock units, \$0.9 million related to the Purchase Plan and \$0.1 million in compensation expense amortized from beginning inventory), respectively.

The fair value of stock options granted is established on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Risk-free interest rates	0.87%	1.46%	1.01% - 0.87%	1.46% - 2.20%
Expected volatility rates	45%	44%	45%	44%
Expected dividend yield	0.57%	0.59%	0.51% - 0.57%	0.54% - 0.59%
Expected term of stock options (in years)	6.40	6.00	6.40	6.00
Weighted-average grant date fair value of options granted	\$16.00	\$15.58	\$18.20	\$15.66

The fair value of employees' stock purchase rights under the Purchase Plan was estimated using the Black-Scholes model with the following weighted-average assumptions:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Risk-free interest rates	0.14%	0.16%	0.09% - 0.14%	0.16% - 0.17%
Expected volatility rates	34%	37%	34% - 48%	37%
Expected dividend yield	0.57%	0.59%	0.54% - 0.57%	0.51% - 0.59%
Expected term of purchase right (in years)	0.50	0.50	0.50	0.50
Weighted-average estimated fair value of purchase rights	\$8.55	\$8.93	\$9.40	\$9.15

A summary of stock option activity under the Plans, excluding performance-based shares and restricted stock units, as of September 30, 2012, and changes during the nine months then ended is presented below:

POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Shares (in thousands)	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	3,557	\$ 24.01		
Granted	135	42.66		
Exercised	(663)	20.85		
Forfeited or expired	(5)	21.09		
Outstanding at September 30, 2012	<u>3,024</u>	<u>\$ 25.54</u>	<u>4.39</u>	<u>\$ 18,744</u>
Exercisable at September 30, 2012	<u>2,573</u>	<u>\$ 23.88</u>	<u>3.71</u>	<u>\$ 17,876</u>
Vested and expected to vest at September 30, 2012	<u>3,003</u>	<u>\$ 25.44</u>	<u>4.36</u>	<u>\$ 18,741</u>

The total intrinsic value of options exercised during the three and nine months ended September 30, 2012, was \$0.9 million and \$12.4 million, respectively, and the intrinsic value of options exercised during the three and nine months ended September 30, 2011, was \$1.8 million and \$13.4 million, respectively.

Performance-based Awards

Under the performance-based awards program, the Company grants awards in the first half of the performance year in an amount equal to twice the target number of shares to be issued if the target performance metrics are met. The number of shares that are released at the end of the performance year can range from zero to 200% of the targeted number depending on the Company's performance. The performance metrics of this program are annual targets consisting of net revenue, non-GAAP operating earnings and strategic goals. Each performance-based award granted from the 2007 Plan will reduce the number of shares available for issuance under the 2007 Plan by 2.0 shares.

During the nine months ended September 30, 2012, the Company issued approximately 102,000 performance-based awards to employees and executives. As the net revenue, non-GAAP operating earnings and achievement of strategic goals are considered performance conditions, expenses associated with these awards, net of estimated forfeitures, are recorded throughout the year depending on the number of shares expected to be earned based on progress toward the performance targets. The cost of performance-based awards is determined using the fair value of the Company's common stock on the grant date, reduced by the discounted present value of dividends expected to be declared before the awards vest. If the performance conditions are not achieved, no compensation cost is recognized and any previously recognized compensation is reversed.

The Company expects a portion of the 2012 performance-based award issued to employees and executives will vest, and therefore has accrued stock-based compensation expense for those awards. In the quarter ended September 30, 2011, the Company did not believe the net revenue and non-GAAP operating earnings performance targets would be met in 2011, and therefore reversed \$0.7 million of previously recognized expense during the three months ended September 30, 2011.

A summary of performance-based awards outstanding as of September 30, 2012, and activity during the nine months then ended, is presented below:

	Shares (in thousands)	Weighted- Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	—	\$ —		
Granted	102	37.60		
Vested	—	—		
Forfeited or expired	—	—		
Outstanding at September 30, 2012	<u>102</u>	<u>\$ 37.60</u>	<u>0.25</u>	<u>\$ 3,091</u>
Outstanding and expected to vest at September 30, 2012	<u>62</u>		<u>0.25</u>	<u>\$ 1,895</u>

POWER INTEGRATIONS, INC.

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The weighted-average grant-date fair value per share of performance-based awards ("PSUs") granted in the nine months ended September 30, 2012, was approximately \$37.60. No PSUs were granted in the three months ended September 30, 2012. The weighted-average grant-date fair value per share of PSUs granted in the three and nine months ended September 30, 2011, was approximately \$30.58 and \$36.57, respectively. The grant date fair value of awards released, which were fully vested, in the nine months ended September 30, 2011, was approximately \$3.0 million. There were no performance-based awards released in the three months ended September 30, 2011, or in the three or nine months ended September 30, 2012, as the performance-based awards granted in 2011 and expected to vest in 2012 were canceled without vesting.

Restricted Stock Units (RSUs)

The Company grants restricted stock units to employees under the 2007 Plan. RSUs granted to employees typically vest ratably over a four-year period, and are converted into shares of the Company's common stock upon vesting on a one-for-one basis subject to the employee's continued service to the Company over that period. The fair value of RSUs is determined using the fair value of the Company's common stock on the date of the grant, reduced by the discounted present value of dividends expected to be declared before the awards vest. Compensation expense is recognized on a straight-line basis over the requisite service period of each grant adjusted for estimated forfeitures. Each RSU award granted from the 2007 plan will reduce the number of shares available for issuance under the 2007 Plan by 2.0 shares.

A summary of RSUs outstanding as of September 30, 2012, and changes during the nine months then ended, is as follows:

	Shares (in thousands)	Weighted- Average Grant Date Fair Value Per Share	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2012	458	\$ 36.08		
Granted	281	41.54		
Vested	(113)	36.33		
Forfeited or expired	(17)	36.99		
Outstanding at September 30, 2012	<u>609</u>	<u>\$ 37.59</u>	<u>1.62</u>	<u>\$ 18,534</u>
Outstanding and expected to vest at September 30, 2012	<u>563</u>		<u>1.60</u>	<u>\$ 17,139</u>

The weighted-average grant-date fair value per share of RSUs awarded in the three and nine months ended September 30, 2012, was approximately \$37.05 and \$41.54, respectively, and was approximately \$33.21 and \$36.16 in the three and nine months ended September 30, 2011, respectively.

The grant date fair value of RSUs vested in the three and nine months ended September 30, 2012, was approximately \$0.3 million and \$4.1 million, respectively, and was approximately \$0.2 million and \$2.1 million, in the three and nine months ended September 30, 2011, respectively.

4. FAIR VALUE MEASUREMENTS:

ASC 820-10, *Fair Value Measurements*, clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, ASC 820-10 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices for identical assets in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

The Company's cash and investment instruments are classified within Level 1 or Level 2 of the fair-value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

levels of price transparency. The type of instrument valued based on quoted market prices in active markets primarily includes money market securities. This type of instrument is generally classified within Level 1 of the fair-value hierarchy. The types of instruments valued based on other observable inputs (Level 2 of the fair-value hierarchy) include investment-grade corporate bonds and government, state, municipal and provincial obligations. Such types of investments are valued by using a multi-dimensional relational model, the inputs are primarily benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers, and reference data including market research publications. In the first quarter of 2012, the Company changed its investment policy to allow the sale of long-term and short-term marketable securities prior to their stated maturity date. The Company principally holds securities until maturity; however, they may be sold under certain circumstances, including, but not limited to, the funding of acquisitions and other strategic investments. As a result of this change in policy the Company classified its investment portfolio as available-for-sale as opposed to held-to-maturity as of March 31, 2012. The Company's investments classified as Level 1 and Level 2 are available-for-sale investments, and were recorded at fair market value.

The fair value hierarchy of the Company's marketable securities at September 30, 2012, and December 31, 2011, was as follows (in thousands):

Description	Fair Value Measurement at		
	September 30, 2012		
	September 30, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Money market funds	\$ 147	\$ 147	\$ —
Commercial paper	12,922	—	12,922
Corporate securities	35,605	—	35,605
Total	\$ 48,674	\$ 147	\$ 48,527

Description	Fair Value Measurement at		
	December 31, 2011		
	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Commercial paper	\$ 9,849	\$ —	\$ 9,849
Money market funds	30,190	30,190	—
Certificates of deposit	10,000	—	10,000
Corporate securities	62,940	—	62,940
Total	\$ 112,979	\$ 30,190	\$ 82,789

The Company did not transfer any investments between Level 1, Level 2 or Level 3 of the fair-value hierarchy in the nine months ended September 30, 2012, and the twelve months ended December 31, 2011.

On October 22, 2010, the Company entered into an agreement with a privately held company, SemiSouth Laboratories ("SemiSouth"), as amended, pursuant to which the Company would be obligated to acquire SemiSouth if SemiSouth met certain financial performance conditions on or before December 31, 2013. At September 30, 2012, the Company determined the fair value of this potential obligation to be zero. The Company developed its own assumptions using Level 2 inputs in its fair-market valuation using a market approach valuation technique to determine the fair value of this obligation. The Company updated the estimated fair value of this potential obligation quarterly. Any changes are recorded in its unaudited condensed consolidated statements of income. In March 2012, in consideration for the loan agreement discussed below, the Company entered into an amended agreement with SemiSouth which established a maximum purchase price related to both the Company's option to acquire SemiSouth ("Purchase Option") and its potential obligation to acquire SemiSouth (as discussed above). The Company used Level 3 inputs in its fair-market valuation utilizing the income-approach valuation technique. The Company prepared a discounted cash flow analysis using the following unobservable inputs: weighted average cost of capital, long-term revenue growth, control premium, and discount for lack of marketability. The Company then used the Black-Scholes option pricing model to determine the fair value of the Company's purchase option to be approximately \$6.2 million. The

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Company's valuation technique derived inputs principally from comparable company market data (i.e., correlation values). In October 2012, information became known to the Company that provided evidence that its SemiSouth Purchase Option was other than temporarily impaired as of September 30, 2012, and as a result the fair value of the SemiSouth Purchase Option was deemed to be zero and written off. The charge is reflected in the Company's condensed consolidated statements of income (loss) under the other income (expense), charge related to SemiSouth caption (see Note 15, *Transactions With Third Party*, below for further details on the SemiSouth impairment).

In March 2012 the Company loaned SemiSouth \$18.0 million, and in exchange the Company was issued a promissory note and received the modification discussed above to establish a maximum price under the Purchase Option. The note was classified as Level 3 in the fair-value hierarchy, as there was no market data for this instrument. The estimated fair value of the note was approximately \$13.4 million prior to impairment, consisting of the promissory note of \$18.0 million, net of the unamortized interest discount related to the \$6.2 million Purchase Option (of which \$1.6 million was amortized prior to impairment). In October 2012, information became known to the Company that provided evidence that its loan to SemiSouth was other than temporarily impaired as of September 30, 2012, and as a result the loan to SemiSouth was written off. The charge was reflected in the condensed consolidated statements of income (loss) under the other income (expense), charge related to SemiSouth caption for the three and nine months ended September 30, 2012 (see Note 15, *Transactions With Third Party*, below for further details on the SemiSouth loan). The following table presents the changes in Level 3 investments for the nine months ended September 30, 2012 (in thousands):

	Fair Value Measurement Using Significant Unobservable Inputs (Level 3)
	Note Receivable
Beginning balance at January 1, 2012	\$ —
Purchases and issuances	13,433
Change in fair value	(13,433)
Ending balance at September 30, 2012	\$ —

5. INVENTORIES:

Inventories (which consist of costs associated with the purchases of wafers from offshore foundries and of packaged components from offshore assembly manufacturers, as well as internal labor and overhead associated with the testing of both wafers and packaged components) are stated at the lower of cost (first-in, first-out) or market. Provisions, when required, are made to reduce excess and obsolete inventories to their estimated net realizable values. Inventories consist of the following (in thousands):

	September 30, 2012	December 31, 2011
Raw materials	\$ 9,718	\$ 12,389
Work-in-process	12,532	7,841
Finished goods	24,678	31,780
Total	\$ 46,928	\$ 52,010

6. GOODWILL AND INTANGIBLE ASSETS:

Changes in the carrying amount of goodwill during the nine months ended September 30, 2012, are as follows (in thousands):

	Nine Months Ended September 30, 2012
Balance at January 1, 2012	\$ 14,786
Goodwill acquired during the period	63,492
Goodwill adjustments	—
Ending balance at September 30, 2012	\$ 78,278

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The \$63.5 million of goodwill acquired in 2012 resulted from the purchase of Concept (see Note 14, *Acquisition* , for further details).

Intangible assets consist primarily of developed technology, acquired licenses, customer relationships, trade name, in-process research and development and patent rights, and are reported net of accumulated amortization. In May 2012, the Company acquired Concept, resulting in the addition of the following intangible assets; developed technology of \$23.8 million , which will be amortized over a period of approximately 4 to 12 years; customer relationships of \$16.7 million , which will be amortized over a period of 10 years; and tradename (Concept) of \$3.6 million , which will be amortized over a period of 2 years. The Company amortizes the cost of all intangible assets over the shorter of the estimated useful life or the term of the acquired license or patent rights, which range from 5 to 12 years, with the exception of \$4.7 million of in-process research and development which will be amortized once the development is completed and products are available for sale. The Company does not expect the amortization for its in-process research and development to begin in 2012 . Amortization for acquired intangible assets was approximately \$1.8 million and \$3.3 million in the three and nine months ended September 30, 2012 , respectively, and \$0.2 million and \$0.7 million in the three and nine months ended September 30, 2011 , respectively. The Company does not believe there is any significant residual value associated with the following intangible assets:

	September 30, 2012			December 31, 2011		
	Gross	Accumulated Amortization	Net	Gross	Accumulated Amortization	Net
	(in thousands)					
In-process research and development	\$ 4,690	\$ —	\$ 4,690	\$ 4,690	\$ —	\$ 4,690
Technology licenses	3,000	(1,950)	1,050	3,000	(1,725)	1,275
Patent rights	1,949	(1,949)	—	1,949	(1,949)	—
Developed technology	26,670	(2,019)	24,651	2,920	(829)	2,091
Customer relationships	17,610	(1,271)	16,339	910	(114)	796
Tradename	3,600	(750)	2,850	—	—	—
Other intangibles	37	(37)	—	37	(37)	—
Total intangible assets	\$ 57,556	\$ (7,976)	\$ 49,580	\$ 13,506	\$ (4,654)	\$ 8,852

The estimated future amortization expense related to intangible assets at September 30, 2012 , is as follows:

Fiscal Year	Estimated Amortization (in thousands)
2012 (remaining 3 months)	\$ 1,841
2013	7,405
2014	6,072
2015	5,009
2016	4,394
Thereafter	20,169
Total (1)	\$ 44,890

- (1) The total above excludes \$4.7 million of in-process research and development that will be amortized upon completion of development over the estimated useful life of the technology.

7. SIGNIFICANT CUSTOMERS AND EXPORT SALES:
Segment Reporting

The Company is organized and operates as one reportable segment, the design, development, manufacture and marketing of integrated circuits and related components for use primarily in the high-voltage power-conversion market. The Company's chief operating decision maker, the Chief Executive Officer, reviews financial information presented on a

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

consolidated basis for purposes of making operating decisions and assessing financial performance.

Customer Concentration

Ten customers accounted for approximately 64% and 65% of net revenues for the three and nine months ended September 30, 2012 , and 65% in both the three and nine months ended September 30, 2011 . A significant portion of these revenues are attributable to sales of the Company's products to distributors of electronic components. These distributors sell the Company's products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers.

The following customers accounted for 10% or more of total net revenues:

<u>Customer</u>	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30,</u>		<u>September 30,</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
A	20%	19%	21%	19%
B	12%	12%	12%	12%

Customers A and B are distributors of the Company's products. No other customers accounted for 10% or more of the Company's net revenues in those periods.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash investments, trade receivables, the Company's note from SemiSouth and the Company's lease line of credit to SemiSouth. The Company has cash investment policies that limit cash investments to low-risk investments. The SemiSouth related transactions were outside of this cash investment policy and were approved by the Board of Directors. With respect to SemiSouth related transactions refer to Note 15, *Transactions With Third Party* , for further details on the impairment. With respect to trade receivables, the Company performs ongoing evaluations of its customers' financial conditions and requires letters of credit whenever deemed necessary. Additionally, the Company establishes an allowance for doubtful accounts based upon factors surrounding the credit risk of specific customers, historical trends related to past write-offs and other relevant information. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit exposure related to its customers. As of September 30, 2012 , and December 31, 2011 , 72% and 79% , respectively, of accounts receivable were concentrated with the Company's top 10 customers.

The following customers represented 10% or more of accounts receivable:

<u>Customer</u>	<u>September 30,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
A	28%	36%
B	14%	10%

Customers A and B are distributors of the Company's products. No other customers accounted for 10% or more of the Company's accounts receivable in these periods.

International Sales

The Company markets its products through its sales personnel and a worldwide network of distributors. As a percentage of total net revenues, international sales, which consist of domestic and foreign sales to distributors and direct customers outside of the Americas, comprise the following:

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	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Hong Kong/China	47%	40%	45%	38%
Taiwan	17%	18%	17%	21%
Korea	11%	16%	13%	16%
Western Europe (excluding Germany)	10%	10%	10%	10%
Japan	5%	7%	6%	6%
Singapore	1%	2%	2%	2%
Germany	1%	1%	1%	1%
Other	2%	2%	1%	2%
Total foreign revenue	94%	96%	95%	96%

The remainder of the Company's sales are to customers within the Americas, primarily located in the United States.

Product Sales

Revenue mix by end market for the three and nine months ended September 30, 2012 and 2011, was as follows:

<u>End Market</u>	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Consumer	36%	39%	37%	37%
Communications	23%	26%	25%	29%
Industrial	31%	23%	27%	22%
Computer	10%	12%	11%	12%

8. EARNINGS PER SHARE:

Basic earnings (loss) per share is calculated by dividing net income (loss) by the weighted-average shares of common stock outstanding during the period. Diluted earnings per share are calculated by dividing net income (loss) by the weighted-average shares of common stock and dilutive common equivalent shares outstanding during the period. Dilutive common equivalent shares included in this calculation consist of dilutive shares issuable upon the assumed exercise of outstanding common stock options, the assumed vesting of outstanding restricted stock units and performance based awards, and the assumed issuance of awards under the stock purchase plan, as computed using the treasury stock method.

A summary of the earnings per share calculation is as follows (in thousands, except per share amounts):

POWER INTEGRATIONS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Basic earnings (loss) per share:				
Net income (loss)	\$ (44,406)	\$ 7,512	\$ (44,121)	\$ 27,965
Weighted-average common shares	28,908	28,799	28,586	28,789
Basic earnings (loss) per share	\$ (1.54)	\$ 0.26	\$ (1.54)	\$ 0.97
Diluted earnings (loss) per share (1):				
Net income (loss)	\$ (44,406)	\$ 7,512	\$ (44,121)	\$ 27,965
Weighted-average common shares	28,908	28,799	28,586	28,789
Effect of dilutive securities:				
Employee stock plans	—	1,080	—	1,406
Diluted weighted-average common shares	28,908	29,879	28,586	30,195
Diluted earnings (loss) per share	\$ (1.54)	\$ 0.25	\$ (1.54)	\$ 0.93

- (1) The Company includes the shares underlying performance-based awards in the calculation of diluted earnings per share when they become contingently issuable per ASC 260-10, *Earnings per Share* and excludes such shares when they are not contingently issuable. The Company has excluded all performance-based awards underlying the fiscal 2012 and 2011 awards as those shares were not contingently issuable as of the end of the periods reported.

In the three and nine months ended September 30, 2012, all shares attributable to stock-based awards were excluded in the computation of diluted earnings per share, as the Company was in a net loss position. In the three and nine months ended September 30, 2011, 410,000 shares and 276,000 shares respectively, were not included in the computation of diluted earnings per share for the periods then ended because they were determined to be anti-dilutive.

9. PROVISION FOR INCOME TAXES:

During the third quarter of 2012, the Company recorded a charge related to SemiSouth of approximately \$59.2 million of which the Company recognized a \$6.9 million tax benefit, refer to Note 15, *Transactions With Third Party*, for further details on the Company's impairment charge.

In the quarter ended June 30, 2012, the Company reached an understanding regarding the terms for settling with the U.S. Internal Revenue Service ("IRS") and closed out all positions as part of the examination of the Company's income tax returns for the years 2003 through 2006. On August 2, 2012, the IRS signed a formal closing agreement with the Company that is consistent with the intentions of the parties pursuant to their earlier understanding. As a result, the Company re-measured its tax positions based on the facts, circumstances, and information available at June 30, 2012. Further, the agreement confirms that the royalty arrangement between the Company and its foreign subsidiary will conclude on October 31, 2012, resulting in a substantially lower effective tax rate for the Company in future periods.

During the third quarter of 2012 the Company made a one-time payment of taxes and interest totaling \$42.6 million. The provision for income tax in the second quarter of 2012 included a one-time charge of \$44.8 million, comprising \$35.0 million in federal income taxes, net interest of \$5.7 million, and state income taxes (including interest) of approximately \$4.1 million. The impact of the charge was partially offset by the reversal of \$26.9 million of related unrecognized tax benefits that had been recorded as non-current liabilities in the Company's consolidated balance sheets, and by a \$2.2 million reduction of the valuation allowance on the Company's California deferred tax assets, resulting in a net charge of \$15.7 million.

The Company's effective tax rates for the three- and nine-month periods ended September 30, 2012, were 10.0% and (45.1)% respectively, compared with 32.4% and 24.2% for the corresponding periods in 2011. The unfavorable tax rate for the three and nine month periods ended September 30, 2012, was also associated with the impairment and write-off of certain assets related to SemiSouth and the settlement with the IRS. The write off of certain assets resulted in capital losses which negatively impacted the tax rate. Since there are no foreseeable capital gains in the future the Company has placed a valuation allowance offsetting a deferred tax asset which results in an unfavorable impact on the tax rate. The effective tax rates for the

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

three and nine month periods ended September 30, 2011, were lower than the federal statutory rate of 35% due primarily to the geographic distribution of the Company's world-wide earnings and the beneficial impact of the research and experimentation tax credit.

The amount of liabilities for unrecognized tax benefits (net of the federal benefit on state issues) that, if recognized, would favorably affect the effective income-tax rate in any future period are \$10.3 million and \$34.9 million at September 30, 2012, and January 1, 2012, respectively. The primary component of the net change is the \$26.8 million realization of unrecognized tax benefits due to the agreement described above. The Company's continuing practice is to recognize interest and/or penalties related to income-tax matters in income-tax expense. The Company's unrecognized tax benefit liabilities include interest and penalties at September 30, 2012, and January 1, 2012, of \$0.5 million and \$4.4 million, respectively, which were recorded in long-term income taxes payable in the accompanying Condensed Consolidated Balance Sheets. Changes in the Company's unrecognized tax benefits over the next twelve months cannot be reasonably estimated at this time.

The Company has concluded all U.S. federal income tax matters for the years through 2006, and the royalty issue for all tax years after 2003. The fiscal years 2007 through 2009 are also under audit by the IRS.

The Company accounts for income taxes under the provisions of ASC 740. Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Income tax expense includes a provision for federal, state and foreign taxes based on the annual estimated effective tax rate applicable to the Company and its subsidiaries, adjusted for certain discrete items which are fully recognized in the period they occur.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities and projected future taxable income. The Company limits the deferred tax assets recognized related to certain highly-paid officers of the Company to amounts that it estimates will be deductible in future periods based upon the provisions of the Internal Revenue Code Section 162(m). In the event that the Company determines, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, the Company would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with the Company's expectations could have a material impact on its results of operations and financial position.

As of September 30, 2012, the Company continues to maintain a valuation allowance on a portion of its California deferred tax assets as the Company does not believe that it is more likely than not that the deferred tax assets will be fully realized. The Company also maintains a valuation allowance with respect to certain of its deferred tax assets relating primarily to tax credits in certain non-U.S. jurisdictions and anticipated capital losses, as discussed above.

Determining the consolidated provision for income tax expense, income tax liabilities and deferred tax assets and liabilities involves judgment. The Company calculates and provides for income taxes in each of the tax jurisdictions in which it operates, which involves estimating current tax exposures as well as making judgments regarding the recoverability of deferred tax assets in each jurisdiction. The estimates used could differ from actual results, which may have a significant impact on operating results in future periods.

10. INDEMNIFICATIONS:

The Company sells products to its distributors under contracts, collectively referred to as Distributor Sales Agreements ("DSA"). Each DSA contains the relevant terms of the contractual arrangement with the distributor, and generally includes certain provisions for indemnifying the distributor against losses, expenses, and liabilities from damages that may be awarded against the distributor in the event the Company's products are found to infringe upon a patent, copyright, trademark, or other proprietary right of a third party ("Customer Indemnification"). The DSA generally limits the scope of and remedies for the Customer Indemnification obligations in a variety of industry-standard respects, including, but not limited to, limitations based on time and geography, and a right to replace an infringing product. The Company also, from time to time, has granted a specific indemnification right to individual customers.

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company believes its internal development processes and other policies and practices limit its exposure related to such indemnifications. In addition, the Company requires its employees to sign a proprietary information and inventions agreement, which assigns the rights to its employees' development work to the Company. To date, the Company has not had to reimburse any of its distributors or customers for any losses related to these indemnifications and no material claims were outstanding as of September 30, 2012. For several reasons, including the lack of prior indemnification claims and the lack of a monetary liability limit for certain infringement cases, the Company cannot determine the maximum amount of potential future payments, if any, related to such indemnifications.

11. COMMITMENTS:

Purchase Obligation to Financing Company

In July 2011, SemiSouth obtained \$15.0 million of financing through the sale, and concurrent licensing back, of its intellectual property ("IP") with a financing company. In connection with this arrangement, the Company entered into a contingent purchase commitment with the financing company for SemiSouth's IP. The contingent purchase commitment requires the Company to purchase the IP previously owned by SemiSouth from its new owner for \$15.0 million (plus reimbursement of certain expenses) under certain conditions generally relating to SemiSouth's failure to make certain payments or SemiSouth's insolvency. As of September 30, 2012, the Company has a \$15.0 million letter of credit to the financing company to secure the contingent purchase commitment. Additionally, the Company believes it is probable that the financing company that currently owns SemiSouth's intellectual property will exercise its contractual rights to put SemiSouth's intellectual property to the Company under the terms of the contingent purchase agreement between the Company and the financing company. Based on SemiSouth's current financial situation and likely closure, the Company estimates that this intellectual property has no value, and has therefore accrued a charge of \$15.3 million related to this contingent obligation. Refer to Note 15, *Transactions With Third Party*, for further details on SemiSouth.

Supplier Agreements

The Company purchases wafers through purchase orders from its foundries. All but one of the Company's wafer agreements were executed in U.S. currency. Until June 2011, this one foundry required wafer purchases to be in Japanese yen; however, the purchase price within this agreement was fixed at a base rate and allowed for some sharing of the impact of exchange rate fluctuations from the base rate. The currency fluctuation experienced between the time invoices were submitted to the Company until the time the yen was purchased and remitted to the supplier was a financial responsibility of the Company. The Company accounted for the gain or loss related to the payment of these transactions as part of other income or expense. The Company has renegotiated its supply agreement with this foundry to purchase wafers in U.S. currency.

Two of the Company's major suppliers have wafer supply agreements based in U.S. dollars; however, the agreements with these foundries also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, the Company's management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between the Company and each of these suppliers.

12. LEGAL PROCEEDINGS AND CONTINGENCIES:

From time to time in the ordinary course of business, the Company becomes involved in lawsuits, or customers and distributors may make claims against the Company. In accordance with ASC 450-10, the Company makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated.

On October 20, 2004, the Company filed a complaint against Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation (referred to collectively as "Fairchild") in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has and is infringing four of Power Integrations' patents pertaining to PWM integrated circuit devices. Fairchild denied infringement and asked for a declaration from the court that it does not infringe any Power Integration patent and that the patents are invalid. The Court issued a claim construction order on March 31, 2006 which was favorable to the Company. The Court set a first trial on the issues of infringement, willfulness and damages for October 2, 2006. At the close of the first trial, on October 10, 2006, the jury returned a verdict in favor of the Company finding all asserted claims of all four patents-in-suit to be willfully infringed by Fairchild and awarding \$34.0 million in damages. Although the jury awarded damages, at this stage of the proceedings the

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company cannot state the amount, if any, which it might ultimately recover from Fairchild, and no benefits have been recorded in the Company's consolidated financial statements as a result of the damages award. Fairchild also raised defenses contending that the asserted patents are invalid or unenforceable, and the court held a second trial on these issues beginning on September 17, 2007. On September 21, 2007, the jury returned a verdict in the Company's favor, affirming the validity of the asserted claims of all four patents-in-suit. Fairchild submitted further materials on the issue of enforceability along with various other post-trial motions, and the Company filed post-trial motions seeking a permanent injunction and increased damages and attorneys' fees, among other things. On September 24, 2008, the Court denied Fairchild's motion regarding enforceability and ruled that all four patents are enforceable. On December 12, 2008, the Court ruled on the remaining post-trial motions, including granting a permanent injunction, reducing the damages award to \$6.1 million, granting Fairchild a new trial on the issue of willful infringement in view of an intervening change in the law, and denying the Company's motion for increased damages and attorneys' fees with leave to renew the motion after the resolution of the issue of willful infringement. On December 22, 2008, at Fairchild's request, the Court temporarily stayed the permanent injunction for 90 days to permit Fairchild to petition the Federal Circuit Court of Appeals for a further stay. On January 12, 2009, Fairchild filed a notice of appeal challenging the Court's refusal to enter a more permanent stay of the injunction, and Fairchild filed additional motions requesting that both the Federal Circuit and the District Court extend the stay of injunction. The District Court temporarily extended the stay pending the Federal Circuit ruling on Fairchild's pending motion, but the Federal Circuit dismissed Fairchild's appeal and denied its motion on May 5, 2009, and the District Court issued an order on May 13, 2009 confirming the reinstatement of the permanent injunction as originally entered in December 2008. On June 22, 2009, the Court held a brief bench re-trial on the issue of willful infringement, and the parties completed post-trial briefing on the issue of willfulness shortly thereafter. On July 22, 2010, the Court found that Fairchild willfully infringed all four of the asserted patents. The Court also invited briefing on enhanced damages and attorneys' fees, and Fairchild filed a motion requesting that the Court amend its findings regarding willfulness. On January 18, 2011, the Court denied Fairchild's request to amend the findings regarding Fairchild's willful infringement and doubled the damages award against Fairchild but declined to award attorneys' fees. On February 3, 2011, the Court entered final judgment in favor of the Company for a total damages award of \$12.9 million. Fairchild filed a notice of appeal challenging the final judgment and a number of the underlying rulings, and the Company filed a cross-appeal seeking to increase the damages award. Briefing on the appeal is complete, and the appeal was argued on January 11, 2012. A ruling is expected later this year.

On May 9, 2005, the Company filed a Complaint with the U.S. International Trade Commission ("ITC") under section 337 of the Tariff Act of 1930, as amended, 19 U.S.C. section 1337 against System General ("SG"). The Company filed a supplement to the complaint on May 24, 2005. The Company alleged infringement of its patents pertaining to pulse width modulation ("PWM") integrated circuit devices produced by SG, which are used in power conversion applications such as power supplies for computer monitors. The Commission instituted an investigation on June 8, 2005 in response to the Company's complaint. SG filed a response to the ITC complaint asserting that the patents-in-suit were invalid and not infringed. The Company subsequently and voluntarily narrowed the number of patents and claims in suit, which proceeded to a hearing. The hearing on the investigation was held before the Administrative Law Judge ("ALJ") from January 18 to January 24, 2006. Post-hearing briefs were submitted and briefing concluded February 24, 2006. The ALJ's initial determination was issued on May 15, 2006. The ALJ found all remaining asserted claims valid and infringed, and recommended the exclusion of the infringing products as well as certain downstream products that contain the infringing products. After further briefing, on June 30, 2006, the Commission decided not to review the initial determination on liability, but did invite briefs on remedy, bonding and the public interest. On August 11, 2006 the Commission issued an order excluding from entry into the United States the infringing SG PWM chips, and any LCD computer monitors, AC printer adapters and sample/demonstration circuit boards containing an infringing SG chip. The U.S. Customs Service is authorized to enforce the exclusion order. On October 11, 2006, the presidential review period expired without any action from the President, and the ITC exclusion order is now in full effect. SG appealed the ITC decision, and on November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects. On October 27, 2008, SG filed a petition to modify the exclusion order in view of a recent Federal Circuit opinion in an unrelated case, and the Company responded to oppose any modification, but the Commission modified the exclusion order on February 27, 2009. Nevertheless, the exclusion order still prohibits SG and related entities from importing the infringing SG chips and any LCD computer monitors, AC printer adapters, and sample/demonstration circuit boards containing an infringing SG chip.

On May 23, 2008, the Company filed a complaint against Fairchild Semiconductor International, Inc., Fairchild Semiconductor Corporation, and Fairchild's wholly-owned subsidiary System General Corporation in the United States District Court for the District of Delaware. In its complaint, the Company alleged that Fairchild has infringed and is infringing three patents pertaining to power supply controller integrated circuit devices. Fairchild answered the Company's complaint on November 7, 2008, denying infringement and asking for a declaration from the Court that it does not infringe

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

any Power Integrations patent and that the patents are invalid and unenforceable. Fairchild's answer also included counterclaims accusing the Company of infringing three patents pertaining to primary side power conversion integrated circuit devices. Fairchild had earlier brought these same claims in a separate suit against the Company, also in Delaware, which Fairchild dismissed in favor of adding its claims to the Company's already pending suit against Fairchild. The Company has answered Fairchild's counterclaims, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid. Fairchild also filed a motion to stay the case, but the Court denied that motion on December 19, 2008. On March 5, 2009, Fairchild filed a motion for summary judgment to preclude any recovery for post-verdict sales of parts found to infringe in the parties' other ongoing litigation, described above, and the Company filed its opposition and a cross-motion to preclude Fairchild from re-litigating the issues of infringement and damages for those same products. On June 26, 2009, the Court held a hearing on the parties' motions, and on July 9, 2009 the Court issued an order denying the parties' motions but staying proceedings with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case between the parties pending the entry of final judgment in that case; the remainder of the case is proceeding. On December 18, 2009, the Court issued an order construing certain terms in the asserted claims of the Company's and Fairchild's patents in suit. Following the Court's ruling on claim construction, Fairchild withdrew its claim related to one of its patents and significantly reduced the number of claims asserted for the remaining two patents. The parties thereafter filed and argued a number of motions for summary judgment, and the Court denied the majority of the parties' motions but granted the Company's motion to preclude Fairchild from re-arguing validity positions that were rejected in the prior case between the parties. Because the assigned Judge retired at the end of July 2010, the case was re-assigned to a different Judge, and the Court vacated the trial schedule and had the parties provide their input on the appropriate course of action. The Court thereafter set a trial schedule with the jury trial on infringement and validity to begin in July 2011. On February 10, 2011, the Court issued an order maintaining the stay with respect to the products that were found to infringe and which are subject to the injunction in the other Delaware case pending the appeal in that case. On April 18, 2011, the Court rescheduled the trial to begin in January 2012, and on June 2, 2011, the Court moved the trial date to permit the parties to address another patent the Company has accused Fairchild of infringing. Following a trial in April 2012, the jury returned a verdict finding that Fairchild infringes two of the Company's patents, that Fairchild has induced others to infringe the Company's patents, and also upheld the validity of the infringed patents. Of the two remaining counterclaim patents Fairchild asserted in the case, one was found not to be infringed, but the jury found the second patent to be infringed by a limited number of the Company's products, although the jury further found the Company did not induce infringement by any customers, including customers outside the United States. The Company is challenging the validity and enforceability of that patent in post-trial proceedings, issues to be decided by the judge overseeing the case. Nevertheless, the Company estimates that even if the verdict on Fairchild's patent were ultimately upheld, the sales potentially impacted would amount to only about 0.2% of the Company's revenues. The Company will also seek an injunction preventing further infringement of its own patents and is seeking financial damages, as well as enhanced damages for willful infringement, issues to be decided in separate proceedings at a later date.

On June 28, 2004, the Company filed a complaint for patent infringement in the U.S. District Court, Northern District of California, against SG Corporation, a Taiwanese company, and its U.S. subsidiary. The Company's complaint alleged that certain integrated circuits produced by SG infringed and continue to infringe certain of its patents. On June 10, 2005, in response to the initiation of the International Trade Commission (ITC) investigation discussed above, the District Court stayed all proceedings. Subsequent to the completion of the ITC proceedings, the District Court temporarily lifted the stay and scheduled a case management conference. On December 6, 2006, SG filed a notice of appeal of the ITC decision as discussed above. In response, and by agreement of the parties, the District Court vacated the scheduled case management conference and renewed the stay of proceedings pending the outcome of the Federal Circuit appeal of the ITC determination. On November 19, 2007, the Federal Circuit affirmed the ITC's findings in all respects, and SG did not file a petition for review. The parties subsequently filed a motion to dismiss the District Court case without prejudice. On November 4, 2009, the Company re-filed its complaint for patent infringement against SG and its parent corporations, Fairchild Semiconductor International, Inc. and Fairchild Semiconductor Corporation, to address their continued infringement of patents at issue in the original suit that recently emerged from SG requested reexamination proceedings before the U.S. Patent and Trademark Office (USPTO). The Company seeks, among other things, an order enjoining Fairchild and SG from infringing the Company's patents and an award of damages resulting from the alleged infringement. Fairchild has denied infringement and asked for a declaration from the Court that it does not infringe any Power Integrations patent, that the patents are invalid, and that one of the two patents now at issue in the case is unenforceable. On May 5, 2010, Fairchild and SG filed an amended answer including counterclaims accusing the Company of infringing two patents; the Company contests these new claims vigorously, and since that time Fairchild has withdrawn its claim for infringement of one of the patents it asserted against the Company, leaving just one Fairchild patent in the case. The Court held a claim construction hearing on March 24, 2011, and has issued claim construction orders regarding the asserted patents. Discovery is currently under way, with a trial scheduled

POWER INTEGRATIONS, INC.

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for February of 2014. On September 21, 2012, Fairchild filed a motion seeking to add another patent to the case, which the Company opposes.

In February 2010, Fairchild and System General (“SG”) filed suits for patent infringement against the Company, Power Integrations Netherlands B.V., and representative offices of Power Integrations Netherlands in Shanghai and Shenzhen with the Suzhou Intermediate Court in the People's Republic of China. The suits assert four Chinese patents and seek an injunction and damages of approximately \$19.0 million . Power Integrations Netherlands filed invalidation proceedings for all four asserted SG patents in the People's Republic of China Patent Reexamination Board (PRB) of the State Intellectual Property Office (SIPO), and all four challenges were accepted by the PRB, with hearings conducted in September 2010. Early this January, the Company received rulings from the PRB invalidating the majority of the claims Fairchild asserted in litigation, and the PRB determinations are currently on appeal. The Suzhou Court conducted evidentiary hearings in May and July of 2012 and has followed up regarding further submissions since that time; rulings are expected by the end of the year. The Company believes the Fairchild and SG claims discussed above are without merit and contests them vigorously.

On July 11, 2011, the Company filed a complaint in the U.S. District Court, District of Columbia, against David Kappos in his capacity as Director of the United States Patent and Trademark Office (“PTO”) as part of the ongoing reexamination proceedings related to one of the patents asserted against Fairchild and SG in the Delaware litigation described above. The Company filed a motion for summary judgment on a preliminary jurisdictional issue, and the PTO filed a cross-motion to dismiss on this same issue; briefing on these motions is now complete, with a ruling expected in the coming months. No schedule has been set for the case.

On May 1, 2012, Fairchild Semiconductor Corporation and Fairchild's wholly-owned subsidiary, System General Corporation (referred to collectively as “Fairchild”), filed a complaint against the Company in the United States District Court for the District of Delaware. In its complaint, Fairchild alleges that the Company has infringed and is infringing four patents pertaining to power conversion integrated circuit devices. The Company has answered Fairchild's complaint, denying infringement and asking for a declaration from the Court that it does not infringe any Fairchild patent and that the Fairchild patents are invalid, and the Company has also asserted counterclaims against Fairchild for infringement of five of the Company's patents. Fairchild filed a motion to dismiss the Company's counterclaims, which the Company opposes; a ruling is expected later this year. Discovery is under way, with a trial scheduled for October 2014.

The Company is unable to predict the outcome of legal proceedings with certainty, and there can be no assurance that Power Integrations will prevail in the above-mentioned unsettled litigations. These litigations, whether or not determined in Power Integrations' favor or settled, will be costly and will divert the efforts and attention of the Company's management and technical personnel from normal business operations, potentially causing a material adverse effect on the business, financial condition and operating results. Currently, the Company is not able to estimate a loss or a range of loss for the ongoing litigation disclosed above, however adverse determinations in litigation could result in monetary losses, the loss of proprietary rights, subject the Company to significant liabilities, require Power Integrations to seek licenses from third parties or prevent the Company from licensing the technology, any of which could have a material adverse effect on the Company's business, financial condition and operating results.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. In the quarter ended March 31, 2011, the IRS began an audit of fiscal years 2007 through 2009 which is currently in process.

13. RECENT ACCOUNTING PRONOUNCEMENTS:

On January 1, 2012, the Company adopted the following accounting pronouncements:

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement*, ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). The Company adopted these amendments in the first quarter of fiscal 2012.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income* (ASC Topic 220). This amendment gives an entity two options to present the total of comprehensive income, the components of net income, and the components of other comprehensive income. An entity can elect to present comprehensive income in either (1) a single continuous statement of comprehensive income, or (2) in two separate but consecutive statements. In both choices, an entity is required to present each

POWER INTEGRATIONS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. The Company adopted this amendment beginning in the first quarter of 2012.

In September 2011, the FASB issued ASU No. 2011-08, *Testing Goodwill for Impairment*, (ASC Topic 350). Under the amendments in this ASU, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity also has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

14. ACQUISITION:

On May 1, 2012, the Company, through its subsidiaries Power Integrations Netherlands B.V., a Dutch company, and Power Integrations Limited, a Cayman Islands company, completed the acquisition of CT Concept Technologie AG ("Concept" or "Concept Group"), a Swiss company, by acquiring all of the outstanding shares of its Swiss parent companies Concept Beteiligungen AG and CT-Concept Holding AG (the "Acquisition"), pursuant to the Share Purchase Agreement ("Purchase Agreement") described in the Current Report on Form 8-K filed by the Company with the Securities and Exchange Commission on April 5, 2012.

The acquisition has been accounted for using the acquisition method of accounting in accordance with Accounting Standards Codification ("ASC") 805 - Business Combinations. Under the acquisition method of accounting, the total purchase consideration of the acquisition is allocated to the tangible assets and identifiable intangible assets and liabilities assumed based on their relative fair values. The excess of the purchase consideration over the net tangible and identifiable intangible assets is recorded as goodwill, and was derived from expected benefits from technology, cost synergies and knowledgeable and experienced workforce who joined the Company after the acquisition. Goodwill is not expected to be deductible for tax purposes. The purchase price allocation is preliminary since the valuation of the net tangible and identifiable intangible assets is still being finalized. Any measurement period adjustments will be recorded retrospectively to the acquisition date. During the third quarter of 2012, the Company increased goodwill by \$0.9 million due to a decrease in acquired property and equipment, net of a related adjustment to deferred tax liabilities. Of the total purchase price of \$130.7 million (including cash assumed), \$128.3 million was used to fund the acquisition in the second quarter of 2012. Pursuant to the purchase agreement, the purchase price was subject to a net asset value adjustment of approximately \$2.4 million, which was paid to the seller in the third quarter of 2012.

The acquisition furthers the Company's strategic aim to offer highly integrated high-voltage power-conversion products across the widest possible range of power levels and applications. While Power Integrations has historically focused on power supplies up to 500 watts of output, Concept products address higher-power applications, such as industrial motors and renewable energy systems. As such, the combination is complementary to Power Integrations' existing business. Furthermore, Concept also has an expanding addressable market and a growing, profitable revenue stream that are consistent with Power Integrations' financial goals/targets.

The following table summarizes the purchase price and estimated fair values of the assets acquired and the liabilities assumed as of May 1, 2012, the completion of the acquisition of Concept ("Closing Date").

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<u>Assets Acquired</u>	Total Amount (in thousands)
Cash	\$ 14,933
Accounts receivable	3,220
Inventories	10,631
Prepaid expenses and other current assets	2,777
Property and equipment, net	2,310
Intangible assets:	
Developed technology	23,750
Tradenname	3,600
Customer relationships	16,700
Goodwill	63,492
Total assets acquired	141,413
<u>Liabilities assumed</u>	
Current liabilities	4,587
Deferred tax liabilities	5,539
Other liabilities	634
Total liabilities assumed	10,760
Total purchase price	\$ 130,653

The fair value of intangible assets of \$44.1 million has been allocated to the following three asset categories: 1) developed technology, 2) tradenname and 3) customer relationships. The first two will be amortized on a straight line basis over the estimated useful life of the assets. The third intangible asset, customer relationships, will be amortized on an accelerated basis over the estimated life of the asset. The following table represents details of the purchased intangible assets as part of the acquisition:

	Fair Value Amount	Estimated Useful Life
	(in thousands)	(in years)
Developed technology	\$ 23,750	4 - 12
Tradenname	3,600	2
Customer relationships	16,700	10
Total Concept intangibles	\$ 44,050	

The fair value of the identifiable intangible assets: developed technology, trademark and customer relationships were determined based on the following approach.

Developed Technology: The value assigned to the acquired developed technology was determined using the income approach. The royalty savings were estimated by applying an estimated royalty rate to the projected revenues for Concept for each developed technology. The selected royalty rate for the developed technology was based on the Company's analysis of comparable technology, royalty rate indications, and licensing agreements for comparable technologies. The royalty savings were then adjusted for taxes and discounted to present value. The fair value of developed technology was capitalized as of the acquisition date and is being amortized using a straight-line method to cost of revenues over the estimated remaining life of 4 - 12 years.

Tradenname: The value assigned to Concept's tradenname was determined using the income approach. The present value of the expected after-tax royalty savings was added to the sum of the expected amortization tax benefit. The royalty rate was selected based on an analysis of comparable tradenname agreements. In addition, the rate was adjusted based on an analysis of

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Concept's projected performance and the importance of the tradename to the industry. The selected royalty rate was then applied to the projected revenues for the tradename. The fair value of the tradename was capitalized as of the acquisition date and is being amortized using a straight-line method to sales and marketing expenses over the estimated period of use of 2 years.

Customer Relationships: An intangible customer relationship asset was recognized to the extent that the Company was expected to benefit from future revenues reasonably anticipated given the history and operating practices of Concept. The value assigned to customer relationships was determined using the income approach. Forecasted cash flows derived from the acquired customer relationships, net of returns on contributory assets, were discounted to present value. Expectations related to future customer retention were based on historical data and a long-term forecast that was constructed based on the Company's financial projections and expectations. The associated income taxes were based on an assumed tax rate of a hypothetical buyer. The net income was then charged for the required returns of debt-free working capital, net fixed and other assets, developed technology and tradename to derive the residual cash flows related to the customer relationships acquired. The residual cash flows were then discounted to present value. The fair value of customer relationships was capitalized as of the acquisition date and is being amortized on an accelerated basis to sales and marketing expenses over the estimated remaining life of 10 years.

Pro Forma Information

The amount of Concept net revenues included in the Company's condensed consolidated statements of operations for the three and nine months ended September 30, 2012, was \$6.2 million and \$10.8 million, respectively, and is included in the pro forma information below to provide supplemental comparable information. The loss of Concept for the same periods of approximately \$1.2 million and \$2.2 million, respectively, was included in the Company's condensed consolidated statements operations, which includes intangible amortization and amortization of inventory markup. The loss from Concept is estimated because the Company is in the process of integrating Concept's operations and the Company does not maintain product line statements of operations.

For the purpose of the summary unaudited pro forma combined supplemental information, the acquisition was assumed to have occurred as of January 1, 2011. The pro forma combined supplemental information reflects the currency translation from Swiss francs to US dollars for the Concept historical financial statements. The pro forma information for January 1, 2011, to April 30, 2012, has been calculated after applying the Company's accounting policies and adjusting the results of Concept to reflect the additional amortization of intangible assets, and additional cost of revenues related to the inventory markup that would have been charged assuming the fair value adjustments had been incurred as of January 1, 2011. The unaudited pro forma combined financial information is for informational purposes only and does not purport to represent what the Company's actual results would have been if the acquisition had been completed as of the date indicated above, or that may be achieved in the future. The unaudited pro forma combined supplemental information does not include the effects of any cost savings from operating efficiencies or synergies that may result from the acquisition (in thousands, except per share amounts).

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Revenues	\$ 78,045	\$ 83,483	\$ 235,313	\$ 257,438
Net income (loss)	\$ (41,673)	\$ 7,902	\$ (41,110)	\$ 26,276
Earnings (loss) per share - diluted	\$ (1.44)	\$ 0.26	\$ (1.44)	\$ 0.87

15. TRANSACTIONS WITH THIRD PARTY:

The Company's strategic relationship with SemiSouth is evaluated for impairment when events or changes in business circumstances indicate that the carrying amount of SemiSouth related assets may not be recoverable. In evaluating impairment, the Company compares the carrying value of the assets to its estimate of undiscounted future cash flows expected to result from the use of the assets and their eventual disposition. An impairment loss is recognized when estimated future cash flows are less than the carrying amount. Estimates of future cash flows may be internally developed or based on independent appraisals and significant judgment is applied to make the estimates. Changes in the Company's strategy, assumptions and/or market conditions could significantly impact these judgments and require adjustments to its SemiSouth related assets.

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Based on SemiSouth's current financial situation and its likely closure, the Company believes its SemiSouth-related assets are impaired as of September 30, 2012. The Company's third-quarter results include an impairment charge of \$33.9 million, comprising the write-off of \$6.9 million of lease receivables, \$7.0 million of preferred stock, a promissory note (net of imputed interest) in the amount of \$13.2 million, \$6.2 million for the Purchase Option, and other assets of \$0.6 million. The Company has also expensed the prepaid royalty of \$10.0 million as it no longer expects to incorporate SemiSouth's technology in the Company's products.

In addition, the Company believes it is probable that the financing company that currently owns SemiSouth's intellectual property will exercise its contractual rights to put SemiSouth's intellectual property to the Company under the terms of the contingent purchase agreement between the Company and the financing company, refer to Note 11, *Commitments*, for further information. Based on SemiSouth's current financial situation and likely closure, the Company estimates that this intellectual property has no value, and has therefore accrued a charge of \$15.3 million related to this contingent obligation.

On October 22, 2010, the Company purchased SemiSouth preferred stock for \$7.0 million. Also in October 2010, the Company paid \$10.0 million as a prepaid royalty in exchange for the right to use SemiSouth's technology. The Company had intended to amortize the royalty to cost of revenues based on the Company's sales of products incorporating the licensed technology. The Company had classified its strategic relationship with SemiSouth, with a carrying value of \$7.0 million and prepaid royalty of \$10.0 million within Other Assets in the Company's condensed consolidated balance sheet as of December 31, 2011. At September 30, 2012, the Company recorded the above-mentioned impairment charge, which is reflected in the Company's condensed consolidated statements of income (loss), under the operating expenses, charge related to SemiSouth caption.

In February 2011, the Company entered into an agreement with SemiSouth to provide a lease line for the financing of capital equipment. Under the terms of the agreement, SemiSouth could borrow up to \$8.6 million through January 2013, of which a total of \$8.6 million had been funded through September 30, 2012. At September 30, 2012, the Company recorded the above-mentioned impairment charge, and wrote off \$6.9 million which reflected the remaining receivable balance net of the estimated fair value of the underlying equipment of \$0.3 million, and is reflected in the Company's condensed consolidated statements of income (loss), under the other income (expense), charge related to SemiSouth caption.

The Call Option can be exercised by the Company at a multiple of SemiSouth's annualized net operating profits after tax ("NOPAT") (based on the average of this measure over a period of several months), as defined in the agreement. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth. The minimum acquisition price would be \$36.0 million, subject to certain adjustments. Pursuant to an amended agreement entered into in March 2012, the maximum purchase price shall not exceed \$80.0 million.

The Put Option can only be exercised by SemiSouth once certain revenue and profit metrics have been reached. At that time, SemiSouth could obligate the Company to acquire SemiSouth at a multiple of SemiSouth's NOPAT. The multiple is intended to result in an acquisition price equal to the estimated fair value of SemiSouth limited to a maximum of \$80.0 million pursuant to the March 2012 amendment.

In July 2011, SemiSouth obtained \$15.0 million of financing through the sale, and concurrent licensing back, of its intellectual property ("IP") with a financing company. In connection with this arrangement, the Company entered into a contingent purchase commitment with the financing company for SemiSouth's IP, refer to Note 11, *Commitments*, for further information. The contingent purchase commitment requires the Company to purchase the IP previously owned by SemiSouth from its new owner for \$15.0 million (plus reimbursement of certain expenses) under certain conditions generally relating to SemiSouth's failure to make certain payments or SemiSouth's insolvency. In this event, the agreement sets forth a process to be followed before the Company's purchase commitment matures. First, the agreement allows the Company to exercise its Call Option for a certain period of time and under certain conditions. If the Company does not initially exercise its Call Option, then SemiSouth can be sold to a third party during a period of time of up to approximately half a year (which period of time may be shortened by the new SemiSouth IP owner). After that period of time elapses, the Company is obligated to purchase the SemiSouth IP for \$15.0 million (plus reimbursement of certain expenses). The Company currently provides a \$15.0 million letter of credit to the financing company to secure the contingent purchase commitment. As of September 30, 2012, based on SemiSouth's current financial situation and likely closure, the Company estimates that this intellectual property has no value, and has therefore accrued an additional charge of \$15.3 million related to this contingent obligation. The charge is reflected in the Company's condensed consolidated statements of income (loss), under the operating expenses, charge related to SemiSouth caption.

POWER INTEGRATIONS, INC.**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In March 2012, the Company loaned SemiSouth \$18.0 million, and in exchange the Company was issued a promissory note. In consideration for the loan the Company obtained an amendment to its 2010 agreement with SemiSouth to establish a maximum purchase price related to both the Company's option to acquire SemiSouth ("Purchase Option") and its potential obligation to acquire SemiSouth (as discussed above). The Company used Level 3 inputs in its fair-market valuation utilizing the income-approach valuation technique. The Company prepared a discounted cash flow analysis using the following unobservable inputs: weighted average cost of capital, long-term revenue growth, control premium, and discount for lack of marketability. The Company then used a Black-Scholes option pricing model to determine the fair value of the Company's purchase option to be approximately \$6.2 million. The Company's valuation technique derived inputs principally from market data (i.e., correlation values). At September 30, 2012, the Company recorded the above-mentioned impairment charge, and wrote off the promissory note (net of imputed interest) in the amount of \$13.2 million, which is reflected in the Company's condensed consolidated statements of income (loss), under the other income (expense), charge related to SemiSouth caption.

The following table reflects the Company's interest income related to its SemiSouth agreements (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Interest income on note from SemiSouth	\$ 90	\$ —	\$ 204	\$ —
Non-cash interest income on note from SemiSouth	665	—	1,445	—
Interest income from SemiSouth lease line	79	21	243	60
Total interest income from SemiSouth	\$ 834	\$ 21	\$ 1,892	\$ 60

16. BANK LINE OF CREDIT:

In February 2011, the Company entered into an unsecured credit agreement with a bank (the "Credit Agreement"). Pursuant to the Credit Agreement, the Company could request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million. On April 2, 2012, the amount available under this credit agreement was increased to \$65.0 million, the proceeds of which could be used for working capital requirements and other general corporate purposes.

On July 5, 2012, the Company terminated the Credit Agreement and entered into a new Credit Agreement (the "New Credit Agreement") with two banks. The New Credit Agreement provides the Company with a \$100.0 million revolving line of credit to use for general corporate purposes with a \$20 million sublimit for the issuance of standby and trade letters of credit. The Company's ability to borrow under the revolving line of credit is conditioned upon the Company's compliance with specified covenants, including reporting and financial covenants, primarily a modified current ratio and a debt to earnings ratio, with which the Company is currently in compliance. The New Credit Agreement terminates on July 5, 2015; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of September 30, 2012, the Company had no amounts outstanding under the agreement other than a letter of credit mentioned below.

As of September 30, 2012, the Company's has a \$15.0 million letter of credit under the Credit Agreement. Refer to Note 15, *Transactions With Third Party*, for details on the Company's outstanding letter of credit.

17. RETIREMENT PLANS:

In connection with the Company's acquisition of Concept in May 2012, the Company sponsors a defined benefit pension plan ("Pension Plan") in accordance with the legal requirements of Switzerland (refer to Note 14, *Acquisition*, for details on Concept). The plan assets, which provide benefits in the event of an employee's retirement, death or disability, are held in legally autonomous trustee-administered funds that are subject to Swiss law. Benefits are based on the employee's age, years of service and salary, and the plan is financed by contributions by both the employee and the Company.

The net periodic benefit cost of the Pension Plan was not material to the Company's financial statements during the three and nine months ended September 30, 2012. The acquired projected benefit obligation of \$5.1 million, net of plan assets of \$4.5 million, was \$0.6 million as of the Closing Date. The projected benefit obligation, net of plan assets, did not change from the closing date to September 30, 2012. The Company has recorded the unfunded amount as a liability in its Condensed

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NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Consolidated Balance Sheet at September 30, 2012, under the pension liability caption. The Company expects to make contributions to the Pension Plan of approximately \$0.3 million during the current fiscal year.

In accordance with the Compensation-Retirement Benefits Topic of ASC 715-20, the Company will recognize the over-funded or under-funded status of its defined postretirement plan as an asset or liability in its statement of financial position. The company will measure the plan assets and benefit obligations as of the date of the fiscal year-end.

18. SUBSEQUENT EVENT

In October 2012, the Company's board of directors authorized the use of \$50.0 million for the repurchase of the Company's common stock. Repurchases are to be executed according to pre-defined price/volume guidelines set by the board of directors. Authorization of future stock repurchase programs is at the discretion of the board of directors and will depend on the Company's financial condition, results of operations, capital requirements, business conditions as well as other factors.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the condensed consolidated financial statements and the notes to those statements included elsewhere in this Quarterly Report on Form 10-Q, and with the consolidated financial statements and management's discussion and analysis of our financial condition and results of operations in our Annual Report on Form 10-K for the year ended December 31, 2011, filed with the SEC on February 29, 2012. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those contained in these forward-looking statements due to a number of factors, including those discussed in Part II, Item 1A-“Risk Factors” and elsewhere in this report.

Overview

We design, develop, and market analog and mixed-signal integrated circuits (ICs) and other electronic components used in high-voltage power conversion. Our products are used primarily in AC-DC power supplies, which provide power to all manner of electronic applications including mobile phones, computers, home-entertainment equipment, appliances, electronic utility meters, industrial controls and LED lights. Since our May 2012 acquisition of CT-Concept Technologie AG (Concept), we also offer drivers - typically circuit boards containing multiple ICs, electrical isolation components and other circuitry - used to operate arrays of high-voltage, high-power transistors known as IGBT modules. These driver/module combinations are used for power conversion in high-power applications such as industrial motors, solar and wind power systems, electric vehicles and high-voltage DC transmission systems.

We believe that our products enable power converters superior to those designed with competing technologies. We differentiate our products through innovation aimed at helping our customers meet the desired performance specifications for their power converters, including increasingly stringent energy-efficiency and reliability requirements, while minimizing complexity, component count, time-to-market and overall system cost. We invest significant resources in research and development in an effort to achieve this differentiation.

While the size of our addressable market fluctuates with changes in macroeconomic conditions, the market has generally exhibited a modest growth rate over time as growth in unit volumes has largely been offset by reductions in the average selling price of components in this market. Therefore, the growth of our business depends primarily on our penetration of the addressable market, and our success in expanding the addressable market by introducing new products that address a wider range of applications. Our growth strategy includes the following elements:

- *Increase the penetration of our ICs in the “low-power” AC-DC power supply market.* The vast majority of our revenues has historically come from AC-DC power-supply applications requiring 50 watts of output or less. We continue to introduce more advanced products that make our ICs more attractive in this market. We have also increased the size of our sales and field-engineering staff considerably in recent years, and we continue to expand our offerings of technical documentation and design-support tools and services in order to help customers use our ICs. These tools and services include our *PI Expert*[™] design software, which we offer free of charge, and our transformer-sample service.
- *Expand our addressable market to include a wider range of applications and power levels.* In recent years we have introduced IC products that enable us to bring the benefits of integration to power supplies requiring more than 50 watts of output, resulting in a significant expansion of our addressable market. These applications include main power supplies for flat-panel TVs and desktop PCs, as well as power supplies for LED streetlights, game consoles, and notebook computers, among others.

In May 2012 we acquired Concept, further expanding our addressable market to include applications up to a gigawatt of power, including industrial motors, renewable energy systems and electric vehicles, and giving us a presence in the energy generation and distribution markets in addition to the energy consumption market.

- *Capitalize on the growing demand for more energy-efficient electronic products and lighting technologies, cleaner modes of transportation and renewable sources of energy.* Because our products incorporate a variety of energy-efficiency technologies, we believe our ability to penetrate the target markets described above is enhanced by the

desire on the part of policymakers and consumers to reduce energy consumption while also promoting cleaner energy sources. We believe that energy-efficiency is becoming an increasingly important design criterion for power supplies due largely to the emergence of standards and specifications that encourage, and in some cases mandate, the design of more energy-efficient electronic products. While power supplies built with competing technologies are often unable to meet these standards cost-effectively, power supplies incorporating our ICs are generally able to comply with all known efficiency specifications currently in effect.

Additionally, technological advances combined with regulatory and legislative actions are resulting in the adoption of alternative lighting technologies such as light-emitting diodes, or LEDs. We believe this presents a significant opportunity for us because our ICs are used in power-supply, or driver, circuitry for high-voltage LED lighting application such as screw-in replacement bulbs, replacements for fluorescent tubes, signage and street lighting.

The adoption of electric vehicles and renewable energy sources is another trend on which we intend to capitalize; we believe that low-cost, reliable, energy-efficient power-conversion electronics are essential to the success of these technologies, and we believe that the Concept transaction gives us the ability to offer solutions that compare favorably with competing alternatives in terms of cost, efficiency and reliability.

Recent Results

Our net revenues were \$78.0 million and \$226.2 million in the three and nine months ended September 30, 2012, respectively, compared to \$75.1 million and \$232.0 million in the same periods of 2011. The increase for the three-month period was driven by the inclusion of revenues from Concept of \$6.2 million, which we acquired in May 2012. The decrease for the nine-month period reflects lower sales of our products into the communications, computer and consumer end markets, largely as a result of weaker demand generally observed across the broader semiconductor industry, partially offset by the inclusion of Concept revenues of \$10.8 million. Our top ten customers, including distributors that resell to OEMs and merchant power supply manufacturers, accounted for 64% and 65% of our net revenues in the three and nine months ended September 30, 2012, respectively, compared to 65% of our net revenues in both the three and nine months ended September 30, 2011. Our top two customers, both distributors of our products, collectively accounted for approximately 32% and 33% of our net revenues in the three and nine months ended September 30, 2012, respectively. These same two distributors collectively accounted for approximately 31% of our net revenues in both the three and nine months ended September 30, 2011. International sales accounted for 94% and 95% of our net revenues in the three and nine months ended September 30, 2012, respectively, and 96% of our net revenues in both the three and nine months ended September 30, 2011.

Because our industry is intensely price-sensitive, our gross margin (gross profit divided by net revenues) is subject to change based on the relative pricing of solutions that compete with ours. Variations in product and customer mix can also cause our gross margin to fluctuate. Also, because we purchase a large percentage of our silicon wafers from foundries located in Japan, our gross margin is influenced by fluctuations in the exchange rate between the U.S. dollar and the Japanese yen. Changes in the prices of raw materials used in our products, such as copper and gold, can also affect our gross margin. Although our wafer-fabrication and assembly operations are outsourced, as are most of our test operations, a portion of our production costs are fixed in nature. As a result, our unit costs and gross profit margin are impacted by the volume of units we produce.

Our gross profit was 50% and 49% of net revenues in the three and nine months ended September 30, 2012, respectively, compared to 47% of net revenues in both the three and nine months ended September 30, 2011. The increase in gross margin for these periods was due primarily to lower manufacturing costs, including more favorable wafer pricing from our foundries, our migration to a next-generation, lower-cost process technology for many of our products, and the completion of our conversion from five- to six-inch wafers; the increase was also driven by a more favorable end-market mix. These factors were partially offset by higher period costs resulting from the amortization of intangibles and inventory write-up related to our acquisition of Concept (refer to Note 14, *Acquisitions*, in our Notes to Condensed Consolidated Financial Statements, for details).

Total operating expenses in the three and nine months ended September 30, 2012, were \$55.0 million and \$109.2 million, respectively, and \$24.5 million and \$73.7 million in the same periods in 2011, respectively. The year-over-year increase in both periods was driven primarily by our SemiSouth impairment charges. Our third-quarter results include an impairment charge comprising the write-offs of our \$10.0 million prepaid royalty and \$15.3 million related to the contingent purchase commitment under which we expect SemiSouth's intellectual property to be put to us by the financing company that

currently owns it (refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements, for details on the impairment). The increase in operating expenses was also driven by higher payroll and related expenses (including stock-based compensation expenses) due to increased headcount attributable to our acquisition of Concept, and increased amortization of intangible assets, including the Concept tradename and customer relationships (refer to Note 14, *Acquisitions*, in our Notes to Condensed Consolidated Financial Statements, for details).

Our quarterly operating results are difficult to predict and subject to significant fluctuations. We plan our production and inventory levels based on internal forecasts of projected customer demand, which is highly unpredictable and can fluctuate substantially. Customers typically may cancel or reschedule orders on short notice without significant penalty and, conversely, often place orders with very short lead times to delivery. Also, external factors such as global economic conditions and supply-chain dynamics can cause our operating results to be volatile.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. On an ongoing basis, we evaluate our estimates, including those listed below. We base our estimates on historical facts and various other assumptions that we believe to be reasonable at the time the estimates are made. Actual results could differ from those estimates.

Our critical accounting policies are as follows:

- revenue recognition;
- stock-based compensation;
- estimating write-downs for excess and obsolete inventory;
- income taxes; and
- goodwill and intangible assets.

Our critical accounting policies are important to the portrayal of our financial condition and results of operations, and require us to make judgments and estimates about matters that are inherently uncertain. A brief description of these critical accounting policies is set forth below. For more information regarding our accounting policies, see Note 2, *Summary of Significant Accounting Policies*, in our Notes to Condensed Consolidated Financial Statements.

Revenue recognition

Product revenues consist of sales to original equipment manufacturers, or OEMs, merchant power supply manufacturers and distributors. Approximately 74% of our net product sales were made to distributors in the nine months ended September 30, 2012, and 71% in the twelve months ended December 31, 2011. We apply the provisions of Accounting Standard Codification (“ASC”) 605-10 (“ASC 605-10”) and all related appropriate guidance. Revenue is recognized when all of the following criteria have been met: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the price is fixed or determinable, and (4) collectability is reasonably assured. Customer purchase orders are generally used to determine the existence of an arrangement. Delivery is considered to have occurred when title and risk of loss have transferred to our customer. We evaluate whether the price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. With respect to collectability, we perform credit checks for new customers and perform ongoing evaluations of our existing customers' financial condition and requires letters of credit whenever deemed necessary.

Sales to international OEM customers and merchant power supply manufacturers that are shipped from our facility in California are pursuant to Delivered at Frontier, or DAF, shipping terms. As such, title to the product passes to the customer when the shipment reaches the destination country and revenue is recognized upon the arrival of the product in that country. Sales to international OEMs and merchant power supply manufacturers for shipments from our facilities outside of the United States are pursuant to EX Works, or EXW, shipping terms, meaning that title to the product transfers to the customer upon shipment from our foreign warehouses. Shipments to OEMs and merchant power supply manufacturers in the Americas are pursuant to Free on Board, or FOB, point of origin shipping terms meaning that title is passed to the customer upon shipment. Revenue is recognized upon title transfer for sales to OEMs and merchant power supply manufacturers, assuming all other

criteria for revenue recognition are met.

Sales to most distributors are made under terms allowing certain price adjustments and rights of return on our products held by the distributors. As a result of these rights, we defer the recognition of revenue and the costs of revenues derived from sales to distributors until our distributors report that they have sold our products to their customers. Our recognition of such distributor sell-through is based on point of sales reports received from the distributor, at which time the price is no longer subject to adjustment and is fixed, and the products are no longer subject to return to us except pursuant to warranty terms. The gross profit that is deferred upon shipment to the distributor is reflected as “deferred income on sales to distributors” in the accompanying consolidated balance sheets. The total deferred revenue as of September 30, 2012, and December 31, 2011, was approximately \$20.8 million and \$16.7 million, respectively. The total deferred cost as of September 30, 2012, and December 31, 2011, was approximately \$10.4 million and \$8.8 million, respectively.

Frequently, distributors need to sell at a price lower than the standard distribution price in order to win business. At or soon after the distributor invoices its customer, the distributor submits a “ship and debit” price adjustment claim to us to adjust the distributor’s cost from the standard price to the pre-approved lower price. After we verify the claim, a credit memo is issued to the distributor for the ship and debit claim. We maintain a reserve for unprocessed claims and future ship and debit price adjustments. The reserve appears as a reduction to accounts receivable in our accompanying consolidated balance sheets. To the extent future ship and debit claims significantly exceed amounts estimated, there could be a material impact on the deferred revenue and deferred margin ultimately recognized. To evaluate the adequacy of our reserves, we analyze historical ship and debit payments and levels of inventory in the distributor channels.

Sales to certain of our distributors are made under terms that do not include rights of return or price concessions after the product is shipped to the distributor. Accordingly, product revenue is recognized upon shipment and title transfer assuming all other revenue recognition criteria are met.

Stock-based compensation

We apply the provisions of ASC 718-10, *Share-Based Payment*. Under the provisions of ASC 718-10, we recognize the fair value of stock-based compensation in financial statements over the requisite service period of the individual grants, which generally equals a four-year vesting period. We use estimates of volatility, expected term, risk-free interest rate, dividend yield and forfeitures in determining the fair value of these awards and the amount of compensation cost to recognize. Changes in these estimates could result in changes to our compensation charges.

Estimating write-downs for excess and obsolete inventory

When evaluating the adequacy of our valuation adjustments for excess and obsolete inventory, we identify excess and obsolete products and also analyze historical usage, forecasted production based on demand forecasts, current economic trends and historical write-offs. This write-down is reflected as a reduction to inventory in the consolidated balance sheets and an increase in cost of revenues. If actual market conditions are less favorable than our assumptions, we may be required to take additional write-downs, which could adversely impact our cost of revenues and operating results.

Income taxes

Income tax expense is an estimate of current income taxes payable or refundable in the current fiscal year based on reported income before income taxes. Deferred income taxes reflect the effect of temporary differences and carry-forwards that are recognized for financial reporting and income tax purposes.

We account for income taxes under the provisions of ASC 740. Under the provisions of ASC 740, deferred tax assets and liabilities are recognized based on the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases, utilizing the tax rates that are expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. We recognize valuation allowances to reduce any deferred tax assets to the amount that we estimate will more likely than not be realized based on available evidence and management’s judgment. We limit the deferred tax assets recognized related to certain officers’ compensation to amounts that we estimate will be deductible in future periods based upon Internal Revenue Code Section 162(m). In the event that we determine, based on available evidence and management judgment, that all or part of the net deferred tax assets will not be realized in the future, we would record a valuation allowance in the period the determination is made. In addition, the calculation of tax liabilities involves significant judgment in estimating the impact of uncertainties in the application of complex tax laws. Resolution of these uncertainties in a manner inconsistent with our expectations could have a material impact on our results of operations and

financial position.

As of September 30, 2012, we continue to maintain a valuation allowance on a portion of our California deferred tax assets as we believe that it is not more likely than not that the deferred tax assets will be fully realized. We also maintain a valuation allowance with respect to some of our deferred tax assets relating primarily to tax credits in some non-U.S. jurisdictions and certain anticipated capital losses.

Although the Company files U.S. federal, U.S. state, and foreign tax returns, its major tax jurisdiction is the U.S. In the quarter ended March 31, 2011, the IRS began an audit of fiscal years 2007 through 2009 which is currently in process.

Goodwill and intangible assets

In accordance with ASC 350-10, *Goodwill and Other Intangible Assets*, we evaluate goodwill for impairment on an annual basis, or as other indicators of impairment emerge. The provisions of ASC 350-10 require that we perform a two-step impairment test. In the first step, we compare the implied fair value of our single reporting unit to its carrying value, including goodwill. If the fair value of our reporting unit exceeds the carrying amount no impairment adjustment is required. If the carrying amount of our reporting unit exceeds the fair value, step two will be completed to measure the amount of goodwill impairment loss, if any exists. If the carrying value of our single reporting unit's goodwill exceeds its implied fair value, then we record an impairment loss equal to the difference, but not in excess of the carrying amount of the goodwill. Under the amendments of this ASC, ASU No. 2011-08, *Testing Goodwill for Impairment*, beginning in the first quarter of 2012 we have the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. We evaluated goodwill for impairment in the fourth quarter 2011, and concluded that no impairment existed as of December 31, 2011. Additionally, no impairment indicators have been identified during the nine months ended September 30, 2012 .

ASC 350-10 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives, and reviewed for impairment in accordance with ASC 360-10, *Accounting for the Impairment or Disposal of Long-Lived Assets* . We review long-lived assets, such as acquired intangibles and property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We measure recoverability of assets to be held and used by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, we recognize an impairment charge by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

Results of Operations

The following table sets forth certain operating data as a percentage of net revenues for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net revenues	100.0 %	100.0%	100.0 %	100.0%
Cost of revenues	50.3	53.3	50.9	53.0
Gross profit	49.7	46.7	49.1	47.0
Operating expenses:				
Research and development	14.6	13.8	15.1	13.2
Sales and marketing	13.2	10.6	12.2	10.5
General and administrative	10.2	8.2	9.8	8.1
Charge related to SemiSouth	32.4	—	11.2	—
Total operating expenses	70.4	32.6	48.3	31.8
Income (loss) from operations	(20.7)	14.1	0.8	15.3
Other income (expense):				
Charge related to SemiSouth	(43.5)	—	(15.0)	—
Other income, net	1.1	0.7	0.7	0.6
Other income (expense), net	(42.4)	0.7	(14.3)	0.6
Income (loss) before provision (benefit) for income taxes	(63.1)	14.8	(13.5)	15.9
Provision for income taxes	(6.3)	4.8	6.1	3.8
Net income (loss)	(56.8)%	10.0%	(19.6)%	12.1%

Comparison of the Three and Nine Months Ended September 30, 2012 and 2011

Net revenues. Net revenues consist of revenues from product sales, which are calculated net of returns and allowances. Net revenues for the three and nine months ended September 30, 2012, were \$78.0 million and \$226.2 million, respectively, compared with \$75.1 million and \$232.0 million for the same periods in 2011. The increase for the three-month period was driven by the inclusion of revenues from Concept of \$6.2 million, which we acquired in May 2012. The decrease for the nine-month period reflects lower sales of our products into the communications, computer and consumer end markets, largely as a result of weaker demand generally observed across the broader semiconductor industry, partially offset by the inclusion of \$10.8 million of Concept revenues.

Our net revenue mix by end market for the three and nine months ended September 30, 2012, compared to the three and nine months ended September 30, 2011, were as follows:

End Market	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Consumer	36%	39%	37%	37%
Communications	23%	26%	25%	29%
Industrial	31%	23%	27%	22%
Computer	10%	12%	11%	12%

International sales, consisting of sales outside of the Americas based on “ship to” customer locations, were \$73.7 million and \$214.3 million in the three and nine months ended September 30, 2012, and \$71.9 million and \$221.8 million in the same periods of 2011, respectively. Although the power supplies using our products are distributed to end markets worldwide,

most of these power supplies are manufactured in Asia. As a result, sales to this region represented 82% of our net revenues for both the three and nine months ended September 30, 2012, and 84% of our net revenues for both the three and nine months ended September 30, 2011. We expect international sales, and sales to the Asia region in particular, to continue to account for a large portion of our net revenues in the future.

Sales through distributors accounted for 76% and 74% of net revenues in the three and nine months ended September 30, 2012, respectively and 72% and 70% of net revenues in the three and nine months ended September 30, 2011, respectively, with direct sales to OEMs and power supply manufactures accounting for the remainder.

The following customers accounted for 10% or more of total revenues:

<u>Customer</u>	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
A	20%	19%	21%	19%
B	12%	12%	12%	12%

Customers A and B are distributors of our products. No other customers accounted for 10% or more of our net revenues in these periods.

Gross profit. Gross profit is net revenues less cost of revenues. Our cost of revenues consists primarily of costs associated with the purchase of wafers from our foundries, the assembly, packaging and testing of our products by sub-contractors, product testing performed in our own facilities, and overhead associated with the management of our supply chain. Gross margin is gross profit divided by net revenues. The table below compares gross profit and gross margin for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
Net revenues	\$ 78.0	\$ 75.1	\$ 226.2	\$ 232.0
Gross profit	\$ 38.8	\$ 35.0	\$ 111.1	\$ 109.1
Gross margin	49.7%	46.7%	49.1%	47.0%

The increase in gross margin for the three and nine months ended September 30, 2012, compared with the same periods in the prior year was due primarily to lower manufacturing costs, including more favorable wafer pricing from our foundries, our migration to a next-generation, lower-cost process technology for many of our products, and the completion of our conversion from five- to six-inch wafers; the increase was also driven by a more favorable end-market mix. These factors were partially offset by higher period costs resulting from the amortization of intangibles and inventory write-up related to our acquisition of Concept (refer to Note 14, *Acquisitions*, in our Notes to Condensed Consolidated Financial Statements, for details).

Research and development expenses. Research and development, or R&D, expenses consist primarily of employee-related expenses including stock-based compensation and expensed material and facility costs associated with the development of new processes and new products. We also record R&D expenses for prototype wafers related to new products until such products are released to production. The table below compares R&D expenses for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

	<u>Three Months Ended September 30,</u>		<u>Nine Months Ended September 30,</u>	
	<u>2012</u>	<u>2011</u>	<u>2012</u>	<u>2011</u>
Net revenues	\$ 78.0	\$ 75.1	\$ 226.2	\$ 232.0
R&D expenses	\$ 11.4	\$ 10.3	\$ 34.1	\$ 30.6
R&D expenses as a % of net revenue	14.6%	13.8%	15.1%	13.2%

R&D expenses increased in the three and nine months ended September 30, 2012, compared to the same periods in 2011, driven primarily by increased payroll and related expenses resulting from increased headcount due primarily to our acquisition of Concept, and increased stock-based compensation expense due to annual RSU awards granted to employees in addition to RSUs granted to Concept employees. In addition, R&D expenses for 2012 include accrued stock-based compensation expenses related to PSUs that are expected to vest, whereas no PSU stock-based compensation expense was recognized in the corresponding periods of 2011. The increase for the nine-month period also reflects increased product-development expenses related to foundry qualifications and ongoing new-product development.

Sales and marketing expenses. Sales and marketing expenses consist primarily of employee-related expenses, including stock-based compensation, commissions to sales representatives, and facilities expenses, including expenses associated with our regional sales and support offices. Sales and marketing expenses also include the amortization of acquisition-related intangible assets including tradenames and customer relationships. The table below compares sales and marketing expenses for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net revenues	\$ 78.0	\$ 75.1	\$ 226.2	\$ 232.0
Sales and marketing expenses	\$ 10.3	\$ 8.0	\$ 27.6	\$ 24.3
Sales and marketing expenses as a % of net revenue	13.2%	10.6%	12.2%	10.5%

Sales and marketing expenses increased in the three and nine months ended September 30, 2012, compared to the same periods of 2011, due primarily to the acquisition of Concept, which resulted in increased expenses related to amortization of acquired intangible assets, as well as increased headcount, which resulted in higher payroll and related expenses including stock-based compensation expense. In addition, sales and marketing expenses for 2012 include accrued stock-based compensation expenses related to PSUs that are expected to vest, whereas no PSU stock-based compensation expense was recognized in the corresponding periods of 2011.

General and administrative expenses. General and administrative, or G&A, expenses consist primarily of employee-related expenses, including stock-based compensation expenses for administration, finance, human resources and general management, as well as consulting, professional services, legal and auditing expenses. The table below compares G&A expenses for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net revenues	\$ 78.0	\$ 75.1	\$ 226.2	\$ 232.0
G&A expenses	\$ 7.9	\$ 6.1	\$ 22.1	\$ 18.8
G&A expenses as a % of net revenue	10.2%	8.2%	9.8%	8.1%

G&A expenses increased in the three and nine months ended September 30, 2012, compared to the prior year, due to increased headcount from our acquisition of Concept, resulting in increased payroll and related expenses, including stock-based compensation expense. In addition, temporary increases in professional service expenses for the nine-month period of \$0.9 million, associated with the acquisition contributed to the increase.

Charge Related to SemiSouth. In October 2012, information became known to us that provided evidence that our SemiSouth related assets were impaired as of September 30, 2012. As a result we incurred a charge of \$25.3 million as of September 30, 2012, comprising the write-offs of a prepaid royalty of \$10.0 million and \$15.3 million related to the contingent purchase commitment under which we expect SemiSouth's intellectual property to be put to us by the financing company that currently owns it. Refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements for details on the SemiSouth charge.

Other income (expense), net. Other income (expense), net consists primarily of interest income earned on cash and cash equivalents, marketable securities and other investments, and the impact of foreign exchange gain or loss, in addition to an impairment charge related to SemiSouth. The table below compares other income, net for the three and nine months ended

September 30, 2012 and 2011 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net revenues	\$ 78.0	\$ 75.1	\$ 226.2	\$ 232.0
Other income (expense)	\$ (33.1)	\$ 0.6	\$ (32.3)	\$ 1.5
Other income (expense) as a % of net revenue	(42.4)%	0.7%	(14.3)%	0.6%

Other income (expense), net, decreased in the three and nine months ended September 30, 2012, compared to the same periods in 2011. The decrease was related to a charge for SemiSouth of \$33.9 million, comprising the write-off of \$6.9 million of lease receivables, \$7.0 million of preferred stock, a promissory note (net of imputed interest) in the amount of \$13.2 million, \$6.2 million for the Purchase Option, and other assets of \$0.6 million. Refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements for details on the SemiSouth impairment.

Provision for income taxes. Provision for income taxes represents federal, state and foreign taxes.

The table below compares income tax expenses for the three and nine months ended September 30, 2012 and 2011 (dollars in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Income (loss) before provision (benefit) for income taxes	\$ (49.3)	\$ 11.1	\$ (30.4)	\$ 36.9
Provision for income taxes	\$ (4.9)	\$ 3.6	\$ 13.7	\$ 8.9
Effective tax rate	10.0%	32.4%	(45.1)%	24.2%

Our effective tax rates for the three and nine months ended September 30, 2012, were 10.0% and (45.1%), respectively, compared to 32.4% and 24.2% for the three months and nine months ended September 30, 2011, respectively. In the nine months ended September 30, 2012, the effective tax rate was negative as a result of the above-mentioned SemiSouth charge and the IRS audit agreement described in Note 9, *Provision for Income Taxes*, in our Notes to Condensed Consolidated Financial Statements. The audit agreement includes federal and state taxes plus interest charges totaling approximately \$44.8 million, partially offset by the reversal of related unrecognized tax benefits and other items of \$29.1 million, for a net charge of \$15.7 million. Our effective tax rates for the periods ended September 30, 2011, were lower than the statutory rate due primarily to the geographic distribution of our earnings and the beneficial impact of the research and experimentation tax credit.

Liquidity and Capital Resources

As of September 30, 2012, we had \$110.4 million in cash, cash equivalents and short-term and long-term investments, down approximately \$102.4 million from \$212.8 million as of December 31, 2011. As of September 30, 2012, we had working capital, defined as current assets less current liabilities, of \$130.2 million, a decrease of approximately \$87.3 million from \$217.5 million as of December 31, 2011. The decrease in cash, cash equivalents and marketable securities and working capital primarily resulted from the acquisition of Concept (refer to Note 14, *Acquisitions*, in our Notes to Condensed Consolidated Financial Statements, for details) and the payment of \$42.4 million in conjunction with the IRS audit agreement.

In March 2012, we loaned SemiSouth 18.0 million, and in exchange we were issued a promissory note. In October 2012, information became known to us that provided evidence that our loan to SemiSouth was other than temporarily impaired as of September 30, 2012, and as a result the loan was written off. The charge was reflected in the condensed consolidated statements of income (loss) under the other income (expense), charge related to SemiSouth caption for the three and nine months ended September 30, 2012 (see Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements for further details on the SemiSouth loan).

In February 2011, we entered into an unsecured credit agreement with a bank (the "Credit Agreement"). Pursuant to the Credit Agreement, we could request, from time to time until February 2013, advances in an amount not to exceed an aggregate principal amount of \$50.0 million. On April 2, 2012, the amount available under this credit agreement was increased to \$65.0 million, the proceeds of which could be used for working capital requirements and other general corporate purposes.

On July 5, 2012, we terminated the Credit Agreement and entered into a new Credit Agreement (the "New Credit Agreement") with two banks. The New Credit Agreement provides us with a \$100.0 million revolving line of credit to use for general corporate purposes with a \$20.0 million sublimit for the issuance of standby and trade letters of credit. Our ability to borrow under the revolving line of credit is conditioned upon our compliance with specified covenants, including reporting and financial covenants, primarily a modified current ratio and a debt to earnings ratio, with which we are currently in compliance. The New Credit Agreement terminates on July 5, 2015; all advances under the revolving line of credit will become due on such date, or earlier in the event of a default. As of September 30, 2012, we had no amounts outstanding under our agreement other than a letter of credit mentioned below.

In connection with entering into the New Credit Agreement, as of July 5, 2012, our existing \$15.0 million letter of credit under the Credit Agreement with a bank, was deemed to have been issued pursuant to and subject to the terms and conditions of the New Credit Agreement.

The letter of credit was provided in connection with a contingent purchase commitment with a financing company which requires us to purchase IP previously owned by SemiSouth from its new owner for \$15 million (plus reimbursement of certain expenses) under certain conditions, generally relating to SemiSouth's failure to make certain payments or SemiSouth's insolvency. As of September 30, 2012, we believe it is probable that the financing company that currently owns SemiSouth's intellectual property will exercise its contractual rights to put SemiSouth's intellectual property to us under the terms of the contingent purchase agreement between us and the financing company. Based on SemiSouth's current financial situation and likely closure, we estimate that this intellectual property has no value, and have therefore accrued an additional charge of \$15.3 million related to this contingent obligation. Refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements, for details on our agreement.

Operating activities generated cash of \$29.7 million in the nine months ended September 30, 2012. The net loss for this period was \$44.1 million; we also incurred non-cash depreciation, amortization of intangible assets and stock-based compensation expenses of \$11.4 million, \$3.3 million and \$10.5 million, respectively. In addition, we incurred a \$59.2 million (of which \$43.9 million was non-cash) impairment charge related to our SemiSouth assets (refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements, for details on our SemiSouth impairment and charges). Additional sources of cash included (1) a \$15.7 million decline in inventory due to reduced wafer purchases, and (2) a \$4.8 million increase in accounts payable primarily due to the timing of payments and our acquisition of Concept. These sources of cash were partially offset by a (1) a \$28.3 million decrease in taxes payable and other accrued liabilities primarily in connection with our IRS agreement, refer to Note 9, *Provision for Income Tax*, in our Notes to Condensed Consolidated Financial Statements for details on our agreement, and (2) a \$11.3 million increase in prepaid expenses and other assets primarily related to prepaid taxes (in connection with the tax benefit related to the SemiSouth impairment and the above-mentioned tax agreement).

Operating activities generated cash of \$60.0 million in the nine months ended September 30, 2011. Our net income for this period was \$28.0 million; we also incurred non-cash depreciation, amortization of intangibles and stock-based compensation expenses of \$11.3 million, \$0.7 million and \$6.6 million, respectively. Additional sources of cash included (1) a \$10.2 million decline in inventory due to reduced wafer purchases, (2) a \$4.9 million increase in taxes payable and accrued liabilities resulting primarily from an increase in our long-term tax liability and (3) a \$2.8 million decrease in prepaid legal fees and prepaid inventory amortization. These sources of cash were partially offset by (1) a \$4.5 million increase in accounts receivable due to higher shipments at the end of September compared to December and the timing of sales rebate payments in the fourth quarter of 2010 versus the third quarter of 2011 and (2) a \$1.9 million decrease in deferred income on sales to distributors resulting from decreased inventory levels at our distributors.

Our investing activities in the nine months ended September 30, 2012, resulted in a \$109.0 million net use of cash, consisting of: (1) \$115.7 million related to the acquisition of Concept, (2) \$18.0 million for a loan to SemiSouth (refer to Note 15, *Transactions With Third Party*, in our Notes to Condensed Consolidated Financial Statements, for further details) and (3) \$12.2 million for purchases of property and equipment, primarily manufacturing equipment to support our growth, and building improvements in connection with our research and development facility in New Jersey. These uses of cash were partially offset by \$36.8 million of proceeds from maturities of marketable securities.

Our investing activities in the nine months ended September 30, 2011, resulted in a \$45.9 million net use of cash, consisting of (1) \$16.2 million for purchases of property and equipment, primarily manufacturing equipment to support our growth, and building improvements in connection with our research and development facility in New Jersey, (2) \$6.9 million

paid in relation to the acquisition of QSpeed in 2011, (3) \$8.0 million in connection with our lease line of credit to SemiSouth and (4) \$16.1 million, net, for purchases of held-to maturity investments. These uses of cash were partially offset by \$2.2 million in proceeds from the sale of capital equipment.

Our financing activities in the nine months ended September 30, 2012, resulted in net cash proceeds of \$14.2 million. Financing activities consisted primarily of proceeds of \$18.0 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan, partially offset by \$4.3 million for the payment of dividends to stockholders. Our financing activities in the nine months ended September 30, 2011, resulted in a \$21.2 million net use of cash. Financing activities consisted primarily of \$35.8 million for the repurchase of our common stock and \$4.3 million for the payment of dividends to stockholders. This cash usage was partially offset by proceeds of \$18.2 million from the issuance of common stock, including the exercise of employee stock options and the issuance of shares through our employee stock purchase plan.

In January 2012, our board of directors continued dividend payments by declaring four quarterly cash dividends in the amount of \$0.05 per share to be paid to stockholders of record at the end of each quarter in 2012. The first three quarterly dividend payments of approximately \$1.4 million per quarter were made on March 30, 2012, June 29, 2012, and September 28, 2012, with the subsequent quarterly payment to be approximately the same amount. The declaration of any future cash dividend is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions and other factors, as well as a determination that cash dividends are in the best interest of our stockholders.

In October 2012, our board of directors authorized the use of \$50.0 million for the repurchase of our common stock. Repurchases are executed according to pre-defined price/volume guidelines set by the board of directors. Authorization of future stock repurchase programs is at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions as well as other factors.

As of September 30, 2012, we have a contractual obligation related to income tax, which consisted primarily of unrecognized tax benefits of approximately \$10.3 million. The tax obligation was classified as long-term income taxes payable and a portion is recorded in deferred tax assets in our condensed consolidated balance sheet. The settlement period for our income tax liabilities cannot be determined; however, they are not expected to be due within the next year.

In the first quarter of 2011, the IRS informed us that it intended to propose material adjustments to our taxable income for fiscal years 2003 through 2006 related to our intercompany research and development cost-sharing arrangement and related issues. In December 2011, we received an addendum to the notice of proposed adjustments from the IRS related to our intercompany research-and-development cost-sharing arrangement. In the quarter ended June 30, 2012, we reached an agreement with the IRS to settle all positions and close out the examination of our income tax returns for the years 2003 through 2006. Under the agreement, in the third quarter of 2012, we made a one-time payment of taxes and interest totaling approximately \$42.4 million.

Though we believe the IRS's position with respect to the adjustments is inconsistent with applicable tax law, and that we had a meritorious defense to our position, we elected to accept a negotiated agreement that we believe to be in the best interests of our stockholders. The agreement addresses the royalty issue related to our international tax structure for all tax years after 2003 (including the years 2007 - 2009, which are currently being audited by the IRS). Further, the agreement confirms that the royalty arrangement between Power Integrations, Inc. and its foreign subsidiary will conclude on October 31, 2012, resulting in a substantially lower effective tax rate for us in future periods. Also, the agreement will allow us to repatriate up to \$101.9 million from our foreign-based subsidiary in future periods without incurring U.S. income taxes.

There were no other material changes, other than stated in the liquidity section above, outside of the ordinary course of business in our contractual commitments reported in our Annual Report on Form 10-K for the year ended December 31, 2011.

Our existing cash, cash equivalents and investment balances may change during the year due to changes in our planned cash outlays, including changes in incremental costs such as direct and integration costs related to our acquisitions. Our intent is to permanently reinvest our earnings from foreign operations. In the event funds from foreign operations are needed, in addition to the \$101.9 million we can repatriate (less \$20.0 million already repatriated as of September 30, 2012) in connection with our IRS agreement, to fund operations in the United States and if U.S. tax has not already been previously provided, we would be required to accrue and pay additional U.S. taxes in connection with the repatriation of any funds.

If our operating results deteriorate during the remainder of 2012, either as a result of a decrease in customer demand, or severe pricing pressures from our customers or our competitors, or for other reasons, our ability to generate positive cash flow from operations may be jeopardized. In that case, we may be forced to use our cash, cash equivalents and short-term investments, use our credit agreement or seek additional financing from third parties to fund our operations. We believe that cash generated from operations, together with existing sources of liquidity, will satisfy our projected working capital and other cash requirements for at least the next 12 months.

Recent Accounting Pronouncements

On January 1, 2012, we adopted the following accounting pronouncements:

In May 2011, the Financial Accounting Standards Board (FASB) issued amendments to the FASB Accounting Standard Codification (ASC) relating to fair value measurements, Accounting Standards Update (ASU) 2011-04, *Fair Value Measurement*, ASC Topic 820. The amendments clarify the application of existing fair value measurement requirements and results in common measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards (IFRS). We adopted these amendments in the first quarter of 2012, and determined that the adoption did not have a material impact on our condensed consolidated financial statements.

In June 2011, the FASB issued ASU No. 2011-05, *Comprehensive Income* (ASC Topic 220). This amendment gives an entity two options to present the total of comprehensive income, the components of net income, and the components of other comprehensive income. An entity can elect to present comprehensive income in either (1) a single continuous statement of comprehensive income, or (2) in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. We adopted this amendment in the first quarter of 2012, and will disclose other comprehensive income in a separate but consecutive statement following our condensed consolidated statements of income.

In September 2011, the FASB issued ASU No. 2011-08, *Testing Goodwill for Impairment*, (ASC Topic 350). Under the amendments in this ASU, an entity has the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, then the entity is required to perform the second step of the goodwill impairment test to measure the amount of the impairment loss, if any. Under the amendments in this ASU, an entity also has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to performing the first step of the two-step goodwill impairment test. An entity may resume performing the qualitative assessment in any subsequent period.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has not been a material change in our exposure to interest rate risks from that described in our 2011 Annual Report on Form 10-K.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. We consider cash invested in highly liquid financial instruments with a remaining maturity of three months or less at the date of purchase to be cash equivalents. Investments in highly liquid financial instruments with maturities greater than three months are classified as short-term investments. In the first quarter of 2012, we changed our investment policy to allow the sale of long-term and short-term investments prior to their stated maturity date. We generally hold securities until maturity; however, they may now be sold under certain circumstances, including, but not limited to, when necessary for the funding of acquisitions and other strategic investments. As a result of this change in policy we classify our investment portfolio as available-for-sale as opposed to held-to-maturity. We invest in high-credit quality issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we seek to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in safe and high-credit quality securities and by constantly positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer, guarantor or depository. The portfolio includes only marketable securities with active secondary or resale markets to facilitate portfolio liquidity. At September 30, 2012, and December 31, 2011, we held primarily cash equivalents and short-term and long-term investments with fixed interest rates.

Our investment securities are subject to market interest rate risk and will vary in value as market interest rates fluctuate. To minimize market risk, most of our investments subject to market risk mature in less than one year, and therefore if market interest rates were to increase or decrease by 10% from interest rates as of September 30, 2012, or December 31, 2011, the increase or decrease in the fair market value of our portfolio on these dates would not have been material. We monitor our investments for impairment on a periodic basis. Refer to Note 2, *Summary of Significant Accounting Policies*, for a tabular presentation of our available-for-sale investments and the expected maturity dates.

Foreign Currency Exchange Risk. As of September 30, 2012, our primary transactional currency was in U.S. dollars; in addition, we hold cash in Swiss francs as a result of our acquisition of Concept. We completed the acquisition of Concept, which is located in Biel, Switzerland, in the second quarter of 2012. Included in the assets acquired was cash denominated in Swiss francs, which will be used to fund Concept operations. Cash balances held in foreign countries are subject to local banking laws and may bear higher or lower risk than cash deposited in the United States. The following represents the potential impact on our income, before provision for income tax, of a change in the value of the U.S. dollar compared to the Swiss franc as of September 30, 2012. This sensitivity analysis applies a change in the U.S. dollar value of 5% and 10%.

	September 30, 2012	
	5%	10%
Swiss Franc foreign exchange impact (in thousands of USD)	\$ 159	\$ 318

The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc is recorded in other income in our condensed consolidated statements of income (loss).

We have sales offices in various other foreign countries in which our expenses are denominated in the local currency, primary Asia and Western Europe. From time to time we may enter into foreign currency hedging contracts to hedge certain foreign currency transactions. As of September 30, 2012, and December 31, 2011, we did not have an open foreign currency hedge program utilizing foreign currency forward exchange contracts.

Two of our major suppliers, Seiko Epson Corporation, or Epson, and ROHM Lapis Semiconductor Co., Ltd., or Lapis, have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between Power Integrations and each of these suppliers.

Nevertheless, as a result of our above-mentioned supplier agreements, our gross margin is influenced by fluctuations

in the exchange rate between the U.S. dollar and the Japanese yen. All else being equal, a 10% change in the value of the U.S. dollar compared to the Japanese yen would result in a corresponding change in our gross margin of approximately 1 percentage point; this sensitivity may increase or decrease depending on the percentage of our wafer supply that we purchase from some of our Japanese suppliers and could subject our gross profit and operating results to the potential for material fluctuations.

ITEM 4. CONTROLS AND PROCEDURES

Limitation on Effectiveness of Controls

Any control system, no matter how well designed and operated, can provide only reasonable assurance as to the tested objectives. The design of any control system is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote. The inherent limitations in any control system include the realities that judgments related to decision-making can be faulty, and that reduced effectiveness in controls can occur because of simple errors or mistakes. Due to the inherent limitations in a cost-effective control system, misstatements due to error may occur and may not be detected.

Evaluation of Disclosure Controls and Procedures

Management is required to evaluate our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act"). Disclosure controls and procedures are controls and other procedures designed to provide reasonable assurance that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report on Form 10-Q, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include controls and procedures designed to provide reasonable assurance that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure. Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective as of the end of the period covered by this report.

Changes in Internal Control over Financial Reporting

On May 1, 2012, we completed the acquisition of Concept. We have not completed integrating Concept into our systems and control environment as of September 30, 2012. We believe that we have taken the necessary steps to monitor and maintain appropriate internal control over financial reporting during this integration. There were no changes in our internal control over financial reporting during the quarter ended September 30, 2012, which were identified in connection with management's evaluation required by paragraph (d) of Rules 13a-15 and 15d-15 under the Exchange Act, that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information with respect to this item may be found in Note 12, *Legal Proceedings and Contingencies*, in our Notes to Condensed Consolidated Financial Statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q, which information is incorporated herein by reference.

ITEM 1A. RISK FACTORS

In addition to the other information in this report, the following factors should be considered carefully in evaluating our business before purchasing shares of our stock. The risks facing our business have not changed substantively from those discussed in our Annual Report on Form 10-K for the year ended December 31, 2011, except for those risk factors below designated by an asterisk ().*

Our quarterly operating results are volatile and difficult to predict. If we fail to meet the expectations of public market analysts or investors, the market price of our common stock may decrease significantly. Our net revenues and operating results have varied significantly in the past, are difficult to forecast, are subject to numerous factors both within and outside of our control, and may fluctuate significantly in the future. As a result, our quarterly operating results could fall

below the expectations of public market analysts or investors. If that occurs, the price of our stock may decline.

Some of the factors that could affect our operating results include the following:

- the demand for our products declining in the major end markets we serve, which may occur due to competitive factors, supply-chain fluctuations or changes in macroeconomic conditions;
- competitive pressures on selling prices;
- the inability to adequately protect or enforce our intellectual property rights;
- expenses we are required to incur (or choose to incur) in connection with our intellectual property litigations;
- reliance on international sales activities for a substantial portion of our net revenues;
- risks associated with acquisitions and strategic investments;
- our ability to successfully integrate, or realize the expected benefits from, our acquisitions;
- fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen and Swiss franc;
- the volume and timing of delivery of orders placed by us with our wafer foundries and assembly subcontractors, and their ability to procure materials;
- our ability to develop and bring to market new products and technologies on a timely basis;
- earthquakes, terrorists acts or other disasters;
- continued impact of recently enacted changes in securities laws and regulations, including potential risks resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002;
- the lengthy timing of our sales cycle;
- undetected defects and failures in meeting the exact specifications required by our products;
- the ability of our products to penetrate additional markets;
- the volume and timing of orders received from customers;
- an audit by the Internal Revenue Service, for fiscal years 2007 - 2009;
- our ability to attract and retain qualified personnel;
- changes in environmental laws and regulations, including with respect to energy consumption and climate change; and
- interruptions in our information technology systems.

If demand for our products declines in our major end markets, our net revenues will decrease. A limited number of applications of our products, such as cellphone chargers, standby power supplies for PCs, and power supplies for home appliances make up a significant percentage of our net revenues. We expect that a significant level of our net revenues and operating results will continue to be dependent upon these applications in the near term. The demand for these products has been highly cyclical and has been impacted by economic downturns in the past. Any economic slowdown in the end markets that we serve could cause a slowdown in demand for our ICs. When our customers are not successful in maintaining high levels of demand for their products, their demand for our ICs decreases, which adversely affects our operating results. Any significant downturn in demand in these markets would cause our net revenues to decline and could cause the price of our stock to fall.

Intense competition in the high-voltage power supply industry may lead to a decrease in our average selling price and

reduced sales volume of our products. The high-voltage power supply industry is intensely competitive and characterized by significant price sensitivity. Our products face competition from alternative technologies, such as linear transformers, discrete switcher power supplies, and other integrated and hybrid solutions. If the price of competing solutions decreases significantly, the cost effectiveness of our products will be adversely affected. If power requirements for applications in which our products are currently utilized go outside the cost-effective range of our products, some of these alternative technologies can be used more cost effectively. In addition, as our patents expire, our competitors could legally begin using the technology covered by the expired patents in their products, potentially increasing the performance of their products and/or decreasing the cost of their products, which may enable our competitors to compete more effectively. Our current patents may or may not inhibit our competitors from getting any benefit from an expired patent. Our U.S. patents have expiration dates ranging from 2012 to 2029. We cannot assure that our products will continue to compete favorably or that we will be successful in the face of increasing competition from new products and enhancements introduced by existing competitors or new companies entering this market. We believe our failure to compete successfully in the high-voltage power supply business, including our ability to introduce new products with higher average selling prices, would materially harm our operating results.

If we are unable to adequately protect or enforce our intellectual property rights, we could lose market share, incur costly litigation expenses, suffer incremental price erosion or lose valuable assets, any of which could harm our operations and negatively impact our profitability. Our success depends upon our ability to continue our technological innovation and protect our intellectual property, including patents, trade secrets, copyrights and know-how. We are currently engaged in litigation to enforce our intellectual property rights, and associated expenses have been, and are expected to remain, material and have adversely affected our operating results. We cannot assure that the steps we have taken to protect our intellectual property will be adequate to prevent misappropriation, or that others will not develop competitive technologies or products. From time to time, we have received, and we may receive in the future, communications alleging possible infringement of patents or other intellectual property rights of others. Costly litigation may be necessary to enforce our intellectual property rights or to defend us against claimed infringement. The failure to obtain necessary licenses and other rights, and/or litigation arising out of infringement claims could cause us to lose market share and harm our business.

As our patents expire, we will lose intellectual property protection previously afforded by those patents. Additionally, the laws of some foreign countries in which our technology is or may in the future be licensed may not protect our intellectual property rights to the same extent as the laws of the United States, thus limiting the protections applicable to our technology.

If we do not prevail in our litigation, we will have expended significant financial resources, potentially without any benefit, and may also suffer the loss of rights to use some technologies. We are currently involved in a number of patent litigation matters and the outcome of the litigation is uncertain. See Note 10, *Legal Proceedings and Contingencies*, in our Notes to Consolidated Financial Statements. For example, in one of our patent suits the infringing company has been found to infringe four of our patents. Despite the favorable court finding, the infringing party filed an appeal to the damages awarded. In another matter, we are being sued for patent infringement in China, where the outcome of litigation can be more uncertain than in the United States. Should we ultimately be determined to be infringing on another party's patents, or if an injunction is issued against us while litigation is pending on those claims, such result could have an adverse impact on our ability to sell products found to be infringing, either directly or indirectly. In the event of an adverse outcome, we may be required to pay substantial damages, stop our manufacture, use, sale, or importation of infringing products, or obtain licenses to the intellectual property we are found to have infringed. We have also incurred, and expect to continue to incur, significant legal costs in conducting these lawsuits, including the appeal of the case we won, and our involvement in this litigation and any future intellectual property litigation could adversely affect sales and divert the efforts and attention of our technical and management personnel, whether or not such litigation is resolved in our favor. Thus, even if we are successful in these lawsuits, the benefits of this success may fail to outweigh the significant legal costs we will have incurred.

Our international sales activities account for a substantial portion of our net revenues, which subjects us to substantial risks. Sales to customers outside of the Americas account for, and have accounted for a large portion of our net revenues, including approximately 95% of our net revenues for nine months ended September 30, 2012, and 96% of our net revenues for the year ended December 31, 2011. If our international sales declined and we were unable to increase domestic sales, our revenues would decline and our operating results would be harmed. International sales involve a number of risks to us, including:

- potential insolvency of international distributors and representatives;
- reduced protection for intellectual property rights in some countries;

- the impact of recessionary environments in economies outside the United States;
- tariffs and other trade barriers and restrictions;
- the burdens of complying with a variety of foreign and applicable U.S. Federal and state laws; and
- foreign-currency exchange risk.

Our failure to adequately address these risks could reduce our international sales and materially and adversely affect our operating results. Furthermore, because substantially all of our foreign sales are denominated in U.S. dollars, increases in the value of the dollar cause the price of our products in foreign markets to rise, making our products more expensive relative to competing products priced in local currencies.

We are exposed to risks associated with acquisitions and strategic investments . We have made, and in the future intend to make, acquisitions of, and investments in, companies, technologies or products in existing, related or new markets such as Concept. Acquisitions involve numerous risks, including but not limited to:

- inability to realize anticipated benefits, which may occur due to any of the reasons described below, or for other unanticipated reasons;
- the risk of litigation or disputes with customers, suppliers, partners or stockholders of an acquisition target arising from a proposed or completed transaction;
- impairment of acquired intangible assets and goodwill as a result of changing business conditions, technological advancements or worse-than-expected performance, which would adversely affect our financial results; and
- unknown, underestimated and/or undisclosed commitments, liabilities or issues not discovered in our due diligence of such transactions.

We also in the future may have strategic relationships with other companies, which may decline in value and/or not meet desired objectives. The success of these strategic relationships depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with strategic partners. Moreover, these relationships are often illiquid, such that it may be difficult or impossible for us to monetize such relationships.

Our inability to successfully integrate, or realize the expected benefits from, our acquisitions could adversely affect our results. We have made, and in the future intend to make, acquisitions of other businesses, such as Concept, and with these acquisitions there is a risk that integration difficulties may cause us not to realize expected benefits. The success of the acquisitions could depend, in part, on our ability to realize the anticipated benefits and cost savings (if any) from combining the businesses of the acquired companies and our business, which may take longer to realize than expected.

**Fluctuations in exchange rates, particularly the exchange rate between the U.S. dollar and the Japanese yen and Swiss franc, may impact our gross margin and net income* . Our exchange rate risk related to the Japanese yen includes two of our major suppliers, Epson and Lapis, that have wafer supply agreements based in U.S. dollars; however, our agreements with Epson and Lapis also allow for mutual sharing of the impact of the exchange rate fluctuation between Japanese yen and the U.S. dollar. Each year, our management and these suppliers review and negotiate pricing; the negotiated pricing is denominated in U.S. dollars but is subject to contractual exchange rate provisions. The fluctuation in the exchange rate is shared equally between Power Integrations and each of these suppliers. We completed the acquisition of Concept in the second quarter of 2012, which is located in Biel, Switzerland. Included in the assets acquired was cash denominated in Swiss francs, which will be used to fund Concept operations. The foreign exchange rate fluctuation between the U.S. dollar versus the Swiss franc is recorded in other income in our condensed consolidated statements of income, and material unfavorable exchange rate fluctuations with the Swiss franc could negatively impact our net income.

We depend on third-party suppliers to provide us with wafers for our products and if they fail to provide us sufficient quantities of wafers, our business may suffer . We have supply arrangements for the production of wafers with Lapis, Renesas, X-FAB and Epson. Our contracts with these suppliers expire in April 2018, August 2014, December 2012 and December 2020, respectively. Although some aspects of our relationships with Lapis, Renesas, X-FAB and Epson are contractual, many

important aspects of these relationships depend on their continued cooperation. We cannot assure that we will continue to work successfully with Lapis, Renesas, X-FAB and Epson in the future, and that the wafer foundries' capacity will meet our needs. Additionally, one or more of these wafer foundries could seek an early termination of our wafer supply agreements. Any serious disruption in the supply of wafers from Lapis, Renesas, X-FAB or Epson could harm our business. We estimate that it would take 12 to 24 months from the time we identified an alternate manufacturing source to produce wafers with acceptable manufacturing yields in sufficient quantities to meet our needs.

Although we provide our foundries with rolling forecasts of our production requirements, their ability to provide wafers to us is ultimately limited by the available capacity of the wafer foundry. Any reduction in wafer foundry capacity available to us could require us to pay amounts in excess of contracted or anticipated amounts for wafer deliveries or require us to make other concessions to meet our customers' requirements, or may limit our ability to meet demand for our products. Further, to the extent demand for our products exceeds wafer foundry capacity, this could inhibit us from expanding our business and harm relationships with our customers. Any of these concessions or limitations could harm our business.

If our third-party suppliers and independent subcontractors do not produce our wafers and assemble our finished products at acceptable yields, our net revenues may decline. We depend on independent foundries to produce wafers, and independent subcontractors to assemble and test finished products, at acceptable yields and to deliver them to us in a timely manner. The failure of the foundries to supply us wafers at acceptable yields could prevent us from selling our products to our customers and would likely cause a decline in our net revenues and gross margin. In addition, our IC assembly process requires our manufacturers to use a high-voltage molding compound that has been available from only a few suppliers. These compounds and their specified processing conditions require a more exacting level of process control than normally required for standard IC packages. Unavailability of assembly materials or problems with the assembly process can materially and adversely affect yields, timely delivery and cost to manufacture. We may not be able to maintain acceptable yields in the future.

In addition, if prices for commodities used in our products increase significantly, raw material costs would increase for our suppliers which could result in an increase in the prices our suppliers charge us. To the extent we are not able to pass these costs on to our customers; this would have an adverse effect on our gross margins.

If our efforts to enhance existing products and introduce new products are not successful, we may not be able to generate demand for our products . Our success depends in significant part upon our ability to develop new ICs for high-voltage power conversion for existing and new markets, to introduce these products in a timely manner and to have these products selected for design into products of leading manufacturers. New product introduction schedules are subject to the risks and uncertainties that typically accompany development and delivery of complex technologies to the market place, including product development delays and defects. If we fail to develop and sell new products in a timely manner then our net revenues could decline.

In addition, we cannot be sure that we will be able to adjust to changing market demands as quickly and cost-effectively as necessary to compete successfully. Furthermore, we cannot assure that we will be able to introduce new products in a timely and cost-effective manner or in sufficient quantities to meet customer demand or that these products will achieve market acceptance. Our failure, or our customers' failure, to develop and introduce new products successfully and in a timely manner would harm our business. In addition, customers may defer or return orders for existing products in response to the introduction of new products. When a potential liability exists we will maintain reserves for customer returns, however we cannot assure that these reserves will be adequate.

In the event of an earthquake, terrorist act or other disaster, our operations may be interrupted and our business would be harmed. Our principal executive offices and operating facilities are situated near San Francisco, California, and most of our major suppliers, which are wafer foundries and assembly houses, are located in areas that have been subject to severe earthquakes, such as Japan. Many of our suppliers are also susceptible to other disasters such as tropical storms, typhoons or tsunamis. In the event of a disaster, such as the recent earthquake and tsunami in Japan, we or one or more of our major suppliers may be temporarily unable to continue operations and may suffer significant property damage. Any interruption in our ability or that of our major suppliers to continue operations could delay the development and shipment of our products and have a substantial negative impact on our financial results.

Securities laws and regulations, including potential risk resulting from our evaluation of internal controls under the Sarbanes-Oxley Act of 2002, will continue to impact our results . Complying with the requirements of the Sarbanes-Oxley Act of 2002 and NASDAQ's conditions for continued listing have imposed significant legal and financial compliance costs, and are expected to continue to impose significant costs and management burden on us. These rules and regulations also may make it more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced

coverage or incur substantially higher costs to obtain coverage. These rules and regulations could also make it more difficult for us to attract and retain qualified executive officers and members of our board of directors, particularly qualified members to serve on our audit committee. Further, the rules and regulations under the Dodd-Frank Wall Street Reform and Consumer Protection Act, which became effective in 2011, may impose significant costs and management burden on us.

Additionally, because these laws, regulations and standards promulgated by the Sarbanes-Oxley Act and the Dodd-Frank Act are expected to be subject to varying interpretations, their application in practice may evolve over time as new guidance becomes available. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

Because the sales cycle for our products can be lengthy, we may incur substantial expenses before we generate significant revenues, if any. Our products are generally incorporated into a customer's products at the design stage. However, customer decisions to use our products, commonly referred to as design wins, can often require us to expend significant research and development and sales and marketing resources without any assurance of success. These significant research and development and sales and marketing resources often precede volume sales, if any, by a year or more. The value of any design win will largely depend upon the commercial success of the customer's product. We cannot assure that we will continue to achieve design wins or that any design win will result in future revenues. If a customer decides at the design stage not to incorporate our products into its product, we may not have another opportunity for a design win with respect to that product for many months or years.

Our products must meet exacting specifications, and undetected defects and failures may occur which may cause customers to return or stop buying our products. Our customers generally establish demanding specifications for quality, performance and reliability, and our products must meet these specifications. ICs as complex as those we sell often encounter development delays and may contain undetected defects or failures when first introduced or after commencement of commercial shipments. We have from time to time in the past experienced product quality, performance or reliability problems. If defects and failures occur in our products, we could experience lost revenue, increased costs, including warranty expense and costs associated with customer support and customer expenses, delays in or cancellations or rescheduling of orders or shipments and product returns or discounts, any of which would harm our operating results.

If our products do not penetrate additional markets, our business will not grow as we expect. We believe that our future success depends in part upon our ability to penetrate additional markets for our products. We cannot assure that we will be able to overcome the marketing or technological challenges necessary to penetrate additional markets. To the extent that a competitor penetrates additional markets before we do, or takes market share from us in our existing markets, our net revenues and financial condition could be materially adversely affected.

We do not have long-term contracts with any of our customers and if they fail to place, or if they cancel or reschedule orders for our products, our operating results and our business may suffer. Our business is characterized by short-term customer orders and shipment schedules, and the ordering patterns of some of our large customers have been unpredictable in the past and will likely remain unpredictable in the future. Not only does the volume of units ordered by particular customers vary substantially from period to period, but also purchase orders received from particular customers often vary substantially from early oral estimates provided by those customers for planning purposes. In addition, customer orders can be canceled or rescheduled without significant penalty to the customer. In the past, we have experienced customer cancellations of substantial orders for reasons beyond our control, and significant cancellations could occur again at any time. Also, a relatively small number of distributors, OEMs and merchant power supply manufacturers account for a significant portion of our revenues. Specifically, our top ten customers, including distributors, accounted for 65% of our net revenues in the nine months ended September 30, 2012, and 62% of our net revenues for the year ended December 31, 2011. However, a significant portion of these revenues are attributable to sales of our products through distributors of electronic components. These distributors sell our products to a broad, diverse range of end users, including OEMs and merchant power supply manufacturers, which mitigates the risk of customer concentration to a large degree.

**The IRS is auditing us for fiscal years 2007 through 2009. If the IRS challenges any of the tax positions we have taken and we are not successful in defending our positions, we may be obligated to pay additional taxes, as well as penalties and interest, and may also have a higher effective income tax rate in the future.* Our operations are subject to income and transaction taxes in the United States and in multiple foreign jurisdictions and to review or audit by the IRS and state, local and foreign tax authorities.

We must attract and retain qualified personnel to be successful and competition for qualified personnel is intense in our market. Our success depends to a significant extent upon the continued service of our executive officers and other key

management and technical personnel, and on our ability to continue to attract, retain and motivate qualified personnel, such as experienced analog design engineers and systems applications engineers. The competition for these employees is intense, particularly in Silicon Valley. The loss of the services of one or more of our engineers, executive officers or other key personnel could harm our business. In addition, if one or more of these individuals leaves our employ, and we are unable to quickly and efficiently replace those individuals with qualified personnel who can smoothly transition into their new roles, our business may suffer. We do not have long-term employment contracts with, and we do not have in place key person life insurance policies on, any of our employees.

Changes in environmental laws and regulations may increase our costs related to obsolete products in our existing inventory . Changing environmental regulations and the timetable to implement them continue to impact our customers' demand for our products. As a result there could be an increase in our inventory obsolescence costs for products manufactured prior to our customers' adoption of new regulations. Currently we have limited visibility into our customers' strategies to implement these changing environmental regulations into their business. The inability to accurately determine our customers' strategies could increase our inventory costs related to obsolescence.

Interruptions in our information technology systems could adversely affect our business. We rely on the efficient and uninterrupted operation of complex information technology systems and networks to operate our business. Any significant system or network disruption, including but not limited to new system implementations, computer viruses, security breaches, or energy blackouts could have a material adverse impact on our operations, sales and operating results. We have implemented measures to manage our risks related to such disruptions, but such disruptions could still occur and negatively impact our operations and financial results. In addition, we may incur additional costs to remedy any damages caused by these disruptions or security breaches.

Like other U.S. companies, our business and operating results are subject to uncertainties arising out of economic consequences of current and potential military actions or terrorist activities and associated political instability, and the impact of heightened security concerns on domestic and international travel and commerce. These uncertainties could also lead to delays or cancellations of customer orders, a general decrease in corporate spending or our inability to effectively market and sell our products. Any of these results could substantially harm our business and results of operations, causing a decrease in our revenues.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

In October 2012, our board of directors authorized the use of \$50.0 million for the repurchase of our common stock. Repurchases are executed according to pre-defined price/volume guidelines set by the board of directors. Authorization of future stock repurchase programs are at the discretion of the board of directors and will depend on our financial condition, results of operations, capital requirements, business conditions as well as other factors.

ITEM 5. OTHER INFORMATION

Comprehensive Income

In June 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-05, *Presentation of Comprehensive Income*, which requires companies to present the components of net income and other comprehensive income either in a single continuous statement or in two separate but consecutive statements. ASU No. 2011-05 eliminates the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity. ASU No. 2011-05 does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. Additionally, ASU No. 2011-05 does not affect the calculation or reporting of earnings per share. ASU 2011-05 is effective for reporting periods beginning after December 15, 2011. In December 2011, the FASB issued ASU No. 2011-12, *Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05*. ASU No. 2011-12 defers the changes in ASU No. 2011-05 that pertain to how, when and where reclassification adjustments are presented. We adopted these ASUs retrospectively effective January 1, 2012, and elected to present comprehensive income in a separate statement immediately following the condensed consolidated statements of income (loss). The adoption had no effect on our financial position, results of operations or cash flows. The impact of the adoption to previously issued consolidated financial statements is the presentation of comprehensive income in a separate statement as follows:

	Year Ended		
	December 31,		
	2011	2010	2009
Net income	\$ 34,291	\$ 49,464	\$ 23,269
Other comprehensive income, net of tax			
Foreign currency translation adjustments	(35)	81	61
Total other comprehensive income	(35)	81	61
Total comprehensive income	\$ 34,256	\$ 49,545	\$ 23,330

ITEM 6. EXHIBITS

See the Exhibit Index immediately following the signature page to this Quarterly Report on Form 10-Q, which is incorporated by reference here.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

POWER INTEGRATIONS, INC.

Dated: October 30, 2012

By: /s/ SANDEEP N AYYAR

Sandeep Nayyar
Chief Financial Officer (Duly Authorized Officer and
Principal Financial Officer and Chief Accounting
Officer)

INDEX TO EXHIBITS

<u>EXHIBIT NUMBER</u>	<u>DESCRIPTION</u>
2.1	Share Purchase Agreement, dated March 30, 2012, by and between Heinz Rüedi, Power Integrations Netherlands B.V. and Power Integrations Limited regarding shares of Concept Beteiligungen AG and CT-Concept Holding AG. (As filed with the SEC as Exhibit 2.01 to our Current Report on Form 8-K on May 7, 2012, SEC File No. 000-23441.)*
3.1	Restated Certificate of Incorporation. (As filed with the SEC as Exhibit 3.1 to our Annual Report on Form 10-K on February 29, 2012, SEC File No. 000-23441.)
3.2	Amended and Restated Bylaws. (As filed with the SEC as Exhibit 3.1 to our Current Report on Form 8-K on January 30, 2012, SEC File No. 000-23441.)
4.1	Reference is made to Exhibits 3.1 and 3.2.
10.1	Credit Agreement, dated July 5, 2012, by and between Power Integrations, Inc., Union Bank N.A. and Wells Fargo Bank, National Association.
10.2	Description of Director Equity Compensation Program
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.**
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document

All references in the table above to previously filed documents or descriptions are incorporating those documents and descriptions by reference thereto.

* Confidential treatment has been granted for portions of this exhibit.

** The certifications attached as Exhibits 32.1 and 32.2 accompanying this Form 10-Q, are not deemed filed with the SEC, and are not to be incorporated by reference into any filing of Power Integrations, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this Form 10-Q, irrespective of any general incorporation language contained in such filing.

CREDIT AGREEMENT

THIS CREDIT AGREEMENT (this “Agreement”) is entered into as of July 5, 2012 (the “Closing Date”), by and among POWER INTEGRATIONS, INC., a Delaware corporation (“Borrower”), UNION BANK, N.A. (“Union Bank”), WELLS FARGO BANK, NATIONAL ASSOCIATION (“Wells Fargo”) each of the other financial institutions, if any, listed on **Schedule 1** hereto, as amended from time to time (collectively, including Wells Fargo in its capacity as a lender hereunder, the “Lenders”), Wells Fargo, as administrative agent for the Lenders (in such capacity, “Agent”) and Union Bank as Co-Lead Arranger and Syndication Agent.

RECITALS

Borrower has requested that Lenders extend or continue credit to Borrower as described below, and Lenders have agreed to provide such credit to Borrower on the terms and conditions contained herein.

NOW, THEREFORE, for valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto hereby agree as follows:

ARTICLE I
CREDIT TERMS

SECTION 1.1. LINE OF CREDIT.

(a) Line of Credit. Subject to the terms and conditions of this Agreement, each Lender hereby severally agrees to make advances (each such advance, a “Line of Credit Advance”) to Borrower from time to time up to and including July 5, 2015 (the “Maturity Date”), *provided that*, after giving effect to any Line of Credit Advance: (A) the sum of (1) the Outstanding Amount of all Line of Credit Advances *plus* (2) the Outstanding Amount of all Letter of Credit Obligations shall not exceed One Hundred Million Dollars (\$100,000,000.00) (“Line of Credit”) and (B) the sum of (1) the aggregate Outstanding Amount of Line of Credit Advances of any Lender *plus* (2) such Lender's pro rata share (as set forth on **Schedule 1** hereto, as amended from time to time) (“Pro Rata Share”) *multiplied* by the Outstanding Amount of all Letter of Credit Obligations shall not exceed such Lender's line of credit commitment (as set forth on **Schedule 1** hereto, as amended from time to time) (“Commitment”). The proceeds of the Line of Credit shall be used to refinance all indebtedness outstanding under that certain Credit Agreement, dated as of February 22, 2011, by and between Borrower and Wells Fargo, and for Borrower's general corporate purposes. Line of Credit Advances may be Prime Rate Loans or LIBOR Rate Loans, as further provided herein. Borrower may from time during the term of the Line of Credit borrow, partially or wholly repay its outstanding borrowings, and reborrow, subject to all of the limitations, terms and conditions contained herein.

As used herein, the term “Outstanding Amount” means, (a) with respect to any Line of Credit Advances on any date, the aggregate outstanding principal amount thereof after giving effect to any Line of Credit Advances and prepayments or repayments of such Line of Credit Advances, as the case may be, occurring on such date; and (b) with respect to any Letter of Credit Obligations on any date, the amount of Letter of Credit Obligations on such date after giving effect to any issuance of any Letter of Credit, the extension of the expiry date of any Letter of Credit or the increase of the amount of any Letter of Credit on such date and any other changes in the aggregate amount of the Letter of Credit Obligations as of such date, including as a result of any reimbursements by Borrower of Unreimbursed Amounts.

As used herein, the term “Letter of Credit Obligations” means, at any time, the sum of: (a) the aggregate amount available to be drawn under all outstanding Letters of Credit; *plus* (b) the

aggregate amount of all Letter of Credit Borrowings including all Unreimbursed Amounts. For purposes of computing the amount available to be drawn under any Letter of Credit, the amount of such Letter of Credit shall be deemed to be the stated amount of such Letter of Credit in effect at such time; *provided* that, with respect to any Letter of Credit that, by its terms or the terms of any document related thereto, provides for one or more automatic increases in the stated amount thereof, the amount of such Letter of Credit shall be deemed to be the maximum stated amount of such Letter of Credit after giving effect to all such increases, whether or not such maximum stated amount is in effect at such time. For all purposes of this Agreement, if at any time of determination a Letter of Credit has expired by its terms but any amount may still be drawn thereunder by reason of the operation of Rule 3.14 of the “International Standby Practices 1998” published by the Institute of International Banking Law & Practice (or such later version as may be in effect, to the extent expressly agreed to by Letter of Credit Issuer), such Letter of Credit shall be deemed to be “outstanding” in an amount equal to the amount remaining available to be drawn.

As used herein, the term “Letter of Credit Borrowings” means, an extension of credit resulting from a drawing under any Letter of Credit that has not been reimbursed on the date when made or refinanced as a Line of Credit Advance.

As used herein, the term “Unreimbursed Amounts” means, with respect to any Letter of Credit, any amount drawn thereunder that Borrower has failed to reimburse to Letter of Credit Issuer by 11:00 a.m. on the related date of any payment by Letter of Credit Issuer thereunder.

As used herein, the term “Type” means, with respect to any Line of Credit Advance, its character as a Prime Rate Loan or a LIBOR Rate Loan.

As used herein, the term “Prime Rate Loan” means a Line of Credit Advance that bears interest based upon the Prime Rate.

As used herein, the term “Prime Rate” means at any time the rate of interest most recently announced within Wells Fargo at its principal office as its Prime Rate, with the understanding that the Prime Rate is one of Wells Fargo's base rates and serves as the basis upon which effective rates of interest are calculated for those loans making reference thereto, and is evidenced by the recording thereof after its announcement in such internal publication or publications as Wells Fargo may designate.

As used herein, the term “LIBOR Rate Loan” means a Line of Credit Advance that bears interest based upon LIBOR.

As used herein, the term “LIBOR” means the rate per annum (rounded upward, if necessary, to the nearest 1/8 of 1%) and determined pursuant to the following formula:

$$\text{LIBOR} = \frac{\text{Base LIBOR}}{100\% - \text{LIBOR Reserve Percentage}}$$

As used herein, the term “Base LIBOR” means the rate per annum for United States dollar deposits quoted by Agent as the Inter-Bank Market Offered Rate, with the understanding that such rate is quoted by Agent for the purpose of calculating rates of interest for loans making reference thereto, on the first day of a Fixed Rate Term for delivery of funds on said date for a period of time approximately equal to the number of days in such Fixed Rate Term and in

an amount approximately equal to the principal amount to which such Fixed Rate Term applies. Borrower understands and agrees that Agent may base its quotation of the Inter-Bank Market Offered Rate upon such offers or other market indicators of the Inter-Bank Market as Agent, in its discretion, deems appropriate including, but not limited to, the rate offered for United States dollar deposits on the London Inter-Bank Market.

As used herein, the term “ LIBOR Reserve Percentage ” means the reserve percentage prescribed by the Board of Governors of the Federal Reserve System (or any successor thereto) for “Eurocurrency Liabilities” (as defined in Regulation D of the Federal Reserve Board, as amended), adjusted by Agent for expected changes in such reserve percentage during the applicable Fixed Rate Term.

As used herein, the term “ Fixed Rate Term ” means a period commencing on a Business Day and continuing for one (1), three (3), or six (6) months, as designated by Borrower, during which all or a portion of the outstanding principal balance of any Line of Credit Advance bears interest as a LIBOR Rate Loan; *provided*, that no Fixed Rate Term shall extend beyond the Maturity Date. If any Fixed Rate Term would end on a day that is not a Business Day, then such Fixed Rate Term shall be extended to the next succeeding Business Day.

As used herein, the term “ Business Day ” means any day except Saturday, Sunday or any other day on which commercial banks in California are authorized or required by law to close.

(b) Procedures for Borrowing.

(i) Each Line of Credit Advance, each conversion of Line of Credit Advances from one Type to the other and each continuation of LIBOR Rate Loans shall be made upon Borrower's irrevocable notice to Agent, which may, subject to the provisions of **Section 8.2**, be given by telephone or by approved electronic communication. Each such notice must be received by Agent not later than 11:00 a.m.: (i) three (3) Business Days prior to the requested date of any Line of Credit Advance of, conversion to or continuation of LIBOR Rate Loans or of any conversion of LIBOR Rate Loans to Prime Rate Loans; and (ii) one (1) Business Day prior to the requested date of any Line of Credit Advance of Prime Rate Loans. Notwithstanding anything to the contrary contained herein, but subject to the provisions of **Section 8.2**, any telephonic notice or other electronic communication by Borrower pursuant to this **Section 1.1(b)(i)** may be given by an individual who has been authorized in writing to do so by an appropriate responsible officer of Borrower. Each such telephonic notice or other electronic communication must be confirmed promptly by delivery to Agent of a written loan notice, appropriately completed and signed by an appropriate responsible officer of Borrower before the time of funding by any Lender.

(ii) Each Line of Credit Advance of, conversion to or continuation of LIBOR Rate Loans shall be in a principal amount of \$1,000,000.00 or a whole multiple of \$100,000.00 in excess thereof. Except as provided in **Section 1.2(c)** and **Section 1.3(c)** each borrowing of any Line of Credit Advance consisting of Prime Rate Loans of or conversion to Prime Rate Loans shall be in a principal amount of \$1,000,000.00 or a whole multiple of \$100,000.00 in excess thereof.

(iii) Each loan notice (whether telephonic or written) shall specify: (A) whether Borrower is requesting: (1) a Line of Credit Advance; (2) a conversion of outstanding Line of Credit Advances from one Type to the other; or (3) a continuation of LIBOR Rate Loans; (B) the requested date (which shall be a Business Day) of such borrowing, conversion or continuation, as the case may be; (C) the principal amount of the Line of Credit Advance to be borrowed, converted or continued; (D) the Type of Line of Credit Advance to be borrowed or to which existing Line of Credit Advances are to be converted; and (E) if applicable, the duration of the Fixed Rate Term with respect thereto. If Borrower fails to specify a Type of Line of Credit Advance in a loan notice or if Borrower fails to give a timely notice requesting a conversion or continuation, then the applicable Line of Credit Advance(s) shall

be made as, or converted to, Prime Rate Loans. Any such automatic conversion to Prime Rate Loans shall be effective as of the last day of the Fixed Rate Term then in effect with respect to the applicable LIBOR Rate Loans. If Borrower requests a borrowing of, conversion to, or continuation of LIBOR Rate Loans in any such loan notice, but fails to specify a Fixed Rate Term, it will be deemed to have specified a Fixed Rate Term of one (1) month.

(iv) Following receipt of a loan notice, Agent shall promptly notify each applicable Lender of the amount of its applicable Pro Rata Share of the requested Line of Credit Advances. If Borrower does not timely provide notice of a conversion or continuation, then Agent shall notify each applicable Lender of the details of any automatic conversion to Prime Rate Loans described in the preceding subsection. Each Lender shall make the amount of its applicable Pro Rata Share of the Line of Credit Advance available to Agent in immediately available funds at the office designated by Agent to each Lender (the “Agent's Office”) not later than 1:00 p.m. on the Business Day specified in the applicable loan notice. Upon satisfaction of the applicable conditions set forth in **Section 3.2** (and, in connection with the initial Line of Credit Advance, **Section 3.1**), Agent shall make all funds so received available to Borrower in like funds as received by Agent either by: (A) crediting the account of Borrower on the books of Wells Fargo with the amount of such funds; or (B) wire transfer of such funds, in each case in accordance with instructions provided to (and reasonably acceptable to) Agent by Borrower; *provided* that, if, on the date the loan notice with respect to such Line of Credit Advance is given by Borrower, there are Letter of Credit Borrowings outstanding, then the proceeds of such Borrowing shall be applied, *first*, to the payment in full of any such Letter of Credit Borrowings and, *second*, to Borrower as provided in this subsection.

(v) Except as otherwise provided herein, a LIBOR Rate Loan may be continued or converted only on the last day of an Fixed Rate Term for such LIBOR Rate Loan. During the existence of an Event of Default: (i) no Line of Credit Advances may be requested as, converted to or continued as LIBOR Rate Loans without the consent of Required Lenders; and (ii) Required Lenders may demand that any or all of the then outstanding Line of Credit Advances that are LIBOR Rate Loans be converted immediately to Prime Rate Loans, whereupon Borrower shall pay any amounts due under **Section 1.4(c)** in accordance with the terms thereof due to any such conversion.

As used herein, the term “Required Lenders” means, (i) any time there are only two Lenders, all Lenders, and (ii) any time there are more than two Lenders, Lenders holding Commitments in excess of 66.67% of the aggregate Commitments; *provided* that the Commitments of any Defaulting Lender shall be excluded for purposes of making a determination of Required Lenders.

(vi) Agent shall promptly notify Borrower and the applicable Lenders of the interest rate applicable to any Fixed Rate Term for LIBOR Rate Loans upon determination of such interest rate.

(vii) After giving effect to all Line of Credit Advances, all conversions of Line of Credit Advances from one Type to the other, and all continuations of Line of Credit Advances as the same Type, there shall not be more than three Interest Periods in effect.

SECTION 1.2. LETTERS OF CREDIT.

(a) Letter of Credit Subfeature.

(i) Subject to the terms and conditions of this Agreement, as a subfeature under the Line of Credit, Letter of Credit Issuer agrees, in reliance upon the agreements of Lenders in this **Section 1.2**, from time to time up to and including the fifth Business Day prior to the Maturity Date to issue or cause an affiliate to issue commercial and standby letters of credit for the account of Borrower (each, a “Letter of Credit” and collectively, “Letters of Credit”); *provided* however, that the aggregate Letter of Credit Obligations shall not at any time exceed Twenty Million Dollars (\$20,000,000.00)

(the “ Letter of Credit Sublimit ”), and to honor drawings under the Letters of Credit; *provided* that, after giving effect to any issuance of any Letter of Credit, the extension of the expiry date thereof or the increase of the amount thereof: (A) the sum of (1) the Outstanding Amount of all Line of Credit Advances *plus* (2) the Outstanding Amount of all Letter of Credit Obligations shall not exceed One Hundred Million Dollars (\$100,000,000.00); (B) the sum of (1) the aggregate Outstanding Amount of the Line of Credit Advances of any Lender, *plus* (2) such Lender's Pro Rata Share *multiplied by* the Outstanding Amount of all Letter of Credit Obligations shall not exceed such Lender's Commitment; and (C) the Outstanding Amount of the Letter of Credit Obligations shall not exceed the Letter of Credit Sublimit. Each request by Borrower for the issuance or amendment of a Letter of Credit shall be deemed to be a representation by Borrower that the request complies with the conditions set forth in the proviso to the preceding sentence, and Letter of Credit Issuer shall have no obligation to provide for any issuance of any Letter of Credit, the extension of the expiry date thereof or the increase of the amount thereof if any of the conditions set forth in the proviso to the preceding sentence are not satisfied. Within the foregoing limits, and subject to the terms and conditions hereof, Borrower's ability to obtain Letters of Credit shall be fully revolving, and, accordingly, Borrower may, during the foregoing period, obtain Letters of Credit to replace Letters of Credit that have expired or that have been drawn upon and reimbursed. All Existing Letters of Credit shall be deemed to have been issued pursuant hereto and, from and after the Closing Date, shall be subject to and governed by the terms and conditions hereof.

As used herein, the term “ Letter of Credit Issuer ” means, at any time, the issuer of Letters of Credit hereunder (which, initially, shall be Wells Fargo).

As used herein, the term “ Existing Letters of Credit ” means, the letters of credit identified on **Schedule 2** .

(ii) Subject to **Section 1.2(b)(iii)** , Letter of Credit Issuer shall not issue any Letter of Credit, if: (A) the expiry date of such requested Letter of Credit would occur more than twelve months after the date of issuance or last extension, unless Required Lenders shall have approved such expiry date; or (B) the expiry date of such requested Letter of Credit would occur after the Maturity Date, unless all Lenders shall have approved such expiry date.

(iii) Letter of Credit Issuer shall not have any obligation to issue a Letter of Credit if:

(A) any order, judgment or decree of any governmental authority or arbitrator shall by its terms purport to enjoin or restrain Letter of Credit Issuer from issuing such Letter of Credit, or any law applicable to Letter of Credit Issuer or any request or directive (whether or not having the force of law) from any governmental authority with jurisdiction over Letter of Credit Issuer shall prohibit, or request that Letter of Credit Issuer refrain from, the issuance of letters of credit generally or such Letter of Credit in particular or shall impose upon Letter of Credit Issuer with respect to such Letter of Credit any restriction, reserve or capital requirement (for which Letter of Credit Issuer is not otherwise compensated hereunder) not in effect on the Closing Date, or shall impose upon Letter of Credit Issuer any unreimbursed loss, cost or expense that was not applicable on the Closing Date and which Letter of Credit Issuer in good faith deems material to it;

(B) the issuance of such Letter of Credit would violate one or more policies of Letter of Credit Issuer;

(C) such Letter of Credit is to be denominated in a currency other than Dollars;

(D) any Lender is then in default of its obligations to fund under **Section 1.2(d)** or is otherwise a Defaulting Lender, unless cash collateral or other credit support satisfactory to Letter of Credit Issuer has been pledged or otherwise provided to Letter of Credit Issuer

in respect of such Defaulting Lender's participation in such requested Letter of Credit or Letter of Credit Issuer has otherwise entered into arrangements satisfactory to Letter of Credit Issuer to eliminate Letter of Credit Issuer's risk with respect to such Defaulting Lender;

(E) unless specifically provided for in this Agreement, such Letter of Credit contains any provisions for automatic reinstatement of the stated amount after any drawing thereunder.

(iv) Letter of Credit Issuer shall not have any obligation to amend any Letter of Credit if: (A) Letter of Credit Issuer would have no obligation at such time to issue such Letter of Credit in its amended form under the terms hereof; or (B) the beneficiary of such Letter of Credit does not accept the proposed amendment to such Letter of Credit.

(v) Letter of Credit Issuer shall act on behalf of all Lenders with respect to any Letters of Credit issued by it and the documents associated therewith, and Letter of Credit Issuer shall have all of the benefits and immunities: (A) provided to Agent in **Article VII** with respect to any acts taken or omissions suffered by Letter of Credit Issuer in connection with Letters of Credit issued by it or proposed to be issued by it and any other documents pertaining to such Letters of Credit as fully as if the term "Agent" as used in **Article VII** included Letter of Credit Issuer with respect to such acts or omissions; and (B) as additionally provided herein with respect to Letter of Credit Issuer.

(b) Procedures for Issuance and Amendment of Letters of Credit.

(i) Each Letter of Credit shall be issued or amended, as the case may be, upon the request of Borrower delivered to Letter of Credit Issuer (with a copy to Agent) in the form of a Letter of Credit application, appropriately completed and signed by a responsible officer of Borrower. Such Letter of Credit application must be received by Letter of Credit Issuer and Agent not later than 11:00 a.m. at least two (2) Business Days (or such later date and time as may be agreed to by each of Agent and Letter of Credit Issuer, each in its sole discretion) prior to the proposed issuance date or date of amendment, as the case may be. In the case of a request for an initial issuance of a Letter of Credit, such Letter of Credit application shall specify in form and detail satisfactory to Letter of Credit Issuer: (A) the proposed issuance date of the requested Letter of Credit (which shall be a Business Day); (B) the amount thereof; (C) the expiry date thereof; (D) the name and address of the beneficiary thereof; (E) the documents to be presented by such beneficiary in case of any drawing thereunder; (F) the full text of any certificate to be presented by such beneficiary in case of any drawing thereunder; and (G) such other matters as Letter of Credit Issuer may require. In the case of a request for an amendment of any outstanding Letter of Credit, such Letter of Credit application shall specify in form and detail satisfactory to Letter of Credit Issuer: (1) the Letter of Credit to be amended; (2) the proposed date of the amendment thereof (which shall be a Business Day); (3) the nature of the proposed amendment; and (4) such other matters as Letter of Credit Issuer may require. Additionally, Borrower shall furnish to Letter of Credit Issuer and Agent such other documents and information pertaining to such requested Letter of Credit issuance or amendment, including any related documents, as Letter of Credit Issuer or Agent may require.

(ii) Promptly after receipt of any Letter of Credit application at the address provided for pursuant to **Section 8.2** for receiving Letter of Credit applications and related correspondence, Letter of Credit Issuer will confirm with Agent (by telephone or in writing) that Agent has received a copy of such Letter of Credit application from Borrower and, if not, Letter of Credit Issuer will provide Agent with a copy thereof. Letter of Credit Issuer shall, on the requested date, issue the Letter of Credit requested by Borrower or enter into the applicable amendment, as the case may be, in each case in accordance with Letter of Credit Issuer's usual and customary business practices. Immediately upon the issuance of each Letter of Credit, each Lender shall be deemed to, and hereby irrevocably and unconditionally agrees to, purchase from Letter of Credit Issuer a risk participation in such Letter of Credit equal to such Lender's Pro Rata Share *multiplied by* the face amount of such Letter of

Credit.

(iii) Promptly after its delivery of any Letter of Credit or any amendment to a Letter of Credit to an advising bank with respect thereto or to the beneficiary thereof, Letter of Credit Issuer will also deliver to Borrower and Agent a true and complete copy of such Letter of Credit or amendment.

(c) Drawings and Reimbursements; Funding of Participations.

(i) Upon receipt from the beneficiary of any Letter of Credit of any drawing under such Letter of Credit (or any notice thereof), Letter of Credit Issuer shall notify Borrower and Agent thereof. If Letter of Credit Issuer shall make any payment in respect of a Letter of Credit, Borrower shall reimburse Letter of Credit Issuer the amount of such payment not later than 1:00 p.m. on the date of any payment by Letter of Credit Issuer under any Letter of Credit if Borrower shall have received notice of such payment prior to 11:00 a.m. on such date, or, if such notice has not been received by Borrower prior to such time on such date, then not later than 10:00 a.m. on the Business Day immediately following the day that Borrower receives such notice. If Borrower fails to so reimburse Letter of Credit Issuer, then Agent shall promptly notify each Lender of the related date of any payment by Letter of Credit Issuer under any Letter of Credit, the Unreimbursed Amount and the amount of such Lender's Pro Rata Share of such Unreimbursed Amount. In such event, Borrower shall be deemed to have requested a Line of Credit Advance consisting of Prime Rate Loans to be disbursed on such date in an amount equal to such Unreimbursed Amount, without regard to the minimum and multiples specified in **Section 1.1(b)(ii)** for the principal amount of Prime Rate Loans, but subject to the amount of the unutilized portion of the Commitments and the conditions set forth in **Section 3.2** (other than the delivery of a loan notice). Any notice given by Letter of Credit Issuer or Agent pursuant to this **Section 1.2(c)(i)** may be given by telephone if immediately confirmed in writing; *provided* that the lack of such an immediate confirmation shall not affect the conclusiveness or binding effect of such notice.

(ii) Each Lender shall, upon any notice pursuant to **Section 1.2(c)(i)**, make funds available to Agent for the account of Letter of Credit Issuer at Agent's Office in an amount equal to such Lender's Pro Rata Share *multiplied by* the Unreimbursed Amount not later than 1:00 p.m. on the Business Day specified in such notice by Agent, whereupon, subject to the provisions of **Section 1.2(c)(iii)**, each Lender that so makes funds available shall be deemed to have made a Line of Credit Advance that is a Prime Rate Loan to Borrower in such amount. Agent shall remit the funds so received to Letter of Credit Issuer.

(iii) With respect to any Unreimbursed Amount that is not fully refinanced by a Line of Credit Advance consisting of Prime Rate Loans because the conditions set forth in **Section 3.2** cannot be satisfied or for any other reason, Borrower shall be deemed to have incurred from Letter of Credit Issuer a Letter of Credit Borrowing on the date of such payment by Letter of Credit Issuer under such Letter of Credit in the amount of the Unreimbursed Amount that is not so refinanced, which Letter of Credit Borrowing shall be due and payable on demand (together with interest) and shall bear interest at the Default Rate. In such event, each Lender's payment to Agent for the account of Letter of Credit Issuer pursuant to **Section 1.2(c)(ii)** shall be deemed payment in respect of its participation in such Letter of Credit Borrowing and shall constitute a Line of Credit Advance from such Lender in satisfaction of its participation obligation under this **Section 1.2**.

(iv) Until each Lender funds its Line of Credit Advance pursuant to this **Section 1.2(c)** to reimburse Letter of Credit Issuer for any amount drawn under any Letter of Credit, interest in respect of the amount of such Lender's Pro Rata Share of such amount shall be solely for the account of Letter of Credit Issuer.

(v) Each Lender's obligation to make Line of Credit Advances to reimburse Letter of

Credit Issuer for amounts drawn under Letters of Credit, as contemplated by this **Section 1.2(c)** , shall be absolute and unconditional and shall not be affected by any circumstance, including: (A) any setoff, counterclaim, recoupment, defense or other right that such Lender may have against Letter of Credit Issuer, Borrower or any other person for any reason whatsoever; (B) the occurrence or continuance of a Default; or (C) any other occurrence, event or condition, whether or not similar to any of the foregoing; *provided* that each Lender's obligation to make Line of Credit Advances pursuant to this **Section 1.2(c)** is subject to the conditions set forth in **Section 3.2** (other than delivery by Borrower of a loan notice). No such making of a Line of Credit Advance shall relieve or otherwise impair the obligation of Borrower to reimburse Letter of Credit Issuer for the amount of any payment made by Letter of Credit Issuer under any Letter of Credit, together with interest as provided herein.

As used herein, the term “ Default ” means any Event of Default or any event or condition that, with the giving of notice, the passage of time, or both, would constitute an Event of Default.

(vi) If any Lender fails to make available to Agent for the account of Letter of Credit Issuer any amount required to be paid by such Lender pursuant to the foregoing provisions of this **Section 1.2(c)** by the time specified in **Section 1.2(c)(ii)** , Letter of Credit Issuer shall be entitled to recover from such Lender (acting through Agent), on demand, such amount with interest thereon for the period from the date such payment is required to the date on which such payment is immediately available to Letter of Credit Issuer at a rate per annum equal to the greater of the Prime Rate and a rate determined by Letter of Credit Issuer in accordance with banking industry rules on interbank compensation, *plus* any administrative, processing or similar fees customarily charged by Letter of Credit Issuer in connection with the foregoing. A certificate of Letter of Credit Issuer submitted to any Lender (through Agent) with respect to any amounts owing under this clause (vi) shall be conclusive absent manifest error.

(d) Repayment of Participations .

(i) If, at any time after Letter of Credit Issuer has made a payment under any Letter of Credit and has received from any Lender such Lender's Line of Credit Advance in respect of such payment in accordance with **Section 1.2(c)** , Agent receives for the account of Letter of Credit Issuer any payment in respect of the related Unreimbursed Amount or interest thereon (whether directly from Borrower or otherwise, including proceeds of cash collateral applied thereto by Agent), Agent will distribute to such Lender an amount that equals its Pro Rata Share thereof (appropriately adjusted, in the case of interest payments, to reflect the period of time during which such Lender's Line of Credit Advance was outstanding) in the same funds as those received by Agent.

(ii) If any payment received by Agent for the account of Letter of Credit Issuer pursuant to **Section 1.2(c)(i)** is required to be returned under any proceeding under any Bankruptcy Law (including pursuant to any settlement entered into by Letter of Credit Issuer in its discretion), each Lender shall pay to Agent for the account of Letter of Credit Issuer an amount equal to its Pro Rata Share thereof on the demand of Agent, *plus* interest thereon from the date of such demand to the date such amount is returned by such Lender, at a rate per annum equal to the Prime Rate from time to time in effect. The obligations of Lenders under this clause shall survive the payment in full of the obligations under this Agreement and the termination of this Agreement.

(e) Obligations Absolute . The obligation of Borrower to reimburse Letter of Credit Issuer for each drawing under each Letter of Credit and to repay each Letter of Credit Borrowing is absolute, unconditional and irrevocable and shall be paid strictly in accordance with the terms of this Agreement under all circumstances, including the following:

(i) any lack of validity or enforceability of such Letter of Credit, this Agreement, or any other Loan Document;

(ii) the existence of any claim, counterclaim, setoff, defense or other right that Borrower may have at any time against any beneficiary or any transferee of such Letter of Credit (or any person for whom any such beneficiary or any such transferee may be acting), Letter of Credit Issuer or any other person, whether in connection with this Agreement, the transactions contemplated hereby or by such Letter of Credit or any agreement or instrument relating thereto, or any unrelated transaction;

(iii) any draft, demand, certificate or other document presented under such Letter of Credit proving to be forged, fraudulent, invalid or insufficient in any respect or any statement therein being untrue or inaccurate in any respect; or any loss or delay in the transmission or otherwise of any document required in order to make a drawing under such Letter of Credit;

(iv) any payment by Letter of Credit Issuer under such Letter of Credit against presentation of a draft or certificate that does not strictly comply with the terms of such Letter of Credit; or any payment made by Letter of Credit Issuer under such Letter of Credit to any person purporting to be a trustee in bankruptcy, debtor-in-possession, assignee for the benefit of creditors, liquidator, receiver or other representative of or successor to any beneficiary or any transferee of such Letter of Credit, including any arising in connection with any proceeding under any Bankruptcy Law; or

(v) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing, including any other circumstance that might otherwise constitute a defense available to, or a discharge of, Borrower.

(f) Role of Letter of Credit Issuer. Each Lender and Borrower agree that, in paying any drawing under a Letter of Credit, Letter of Credit Issuer shall not have any responsibility to obtain any document (other than any sight draft, certificates and documents expressly required by the Letter of Credit) or to ascertain or inquire as to the validity or accuracy of any such document or the authority of the person executing or delivering any such document. None of Letter of Credit Issuer, Agent, any of their respective related parties or any correspondent, participant or assignee of Letter of Credit Issuer shall be liable to any Lender for: (i) any action taken or not taken, at the request or with the approval of Lenders or Required Lenders, as applicable, in connection with a Letter of Credit or any related document; (ii) in the absence of gross negligence or willful misconduct, any action taken or not taken in connection with a Letter of Credit or any related document; or (iii) the due execution, effectiveness, validity or enforceability of any document related to any Letter of Credit or related document. As between Borrower and Letter of Credit Issuer, Borrower hereby assumes all risks of the acts or omissions of any beneficiary or transferee with respect to its use of any Letter of Credit; *provided* that this assumption is not intended to, and shall not, preclude Borrower from pursuing such rights and remedies as it may have against the beneficiary or transferee at law or under any other agreement. None of Letter of Credit Issuer, Agent, any of their respective related parties or any correspondent, participant or assignee of Letter of Credit Issuer shall be liable or responsible for any of the matters described in clauses (i) through (v) of **Section 1.2(e)**; *provided* that, notwithstanding anything to the contrary contained in such clauses, Borrower may have a claim against Letter of Credit Issuer, and Letter of Credit Issuer may be liable to Borrower, to the extent, but only to the extent, of any direct, as opposed to consequential or exemplary, damages suffered by Borrower that Borrower proves were caused by Letter of Credit Issuer's willful failure to pay under any Letter of Credit after the presentation to it by the beneficiary of a sight draft and certificate(s) strictly complying with the terms and conditions of a Letter of Credit. In furtherance and not in limitation of the foregoing, Letter of Credit Issuer may accept documents that appear on their face to be in order, without responsibility for further investigation, regardless of any notice or information to the contrary, and Letter of Credit Issuer shall not be responsible for the validity or sufficiency of any document transferring or assigning or purporting to transfer or assign a Letter of Credit or the rights or benefits thereunder or proceeds thereof, in whole or in part, that may prove to be invalid or ineffective for any reason.

(g) Cash Collateral. Upon the request of Agent, if Letter of Credit Issuer has honored any full or partial drawing request under any Letter of Credit and such drawing has resulted in a Letter of Credit Borrowing that remains outstanding after payment thereof is due from Borrower, or if, on or after the

Maturity Date, any Letter of Credit Obligation remains outstanding for any reason without the consent of all Lenders, then Borrower shall, in each such case, immediately cash collateralize the then Outstanding Amount of all Letter of Credit Obligations with an amount equal to 105.00% of such Outstanding Amount. Borrower hereby grants to Agent, for the benefit of Letter of Credit Issuer and Lenders, a security interest in all such cash and deposit accounts and all balances therein and all proceeds of the foregoing.

SECTION 1.3. PRINCIPAL/INTEREST/FEEES.

(a) Interest. Subject to the provisions of subsection **Section 1.3(b)** : (i) each LIBOR Rate Loan shall bear interest on the outstanding principal amount thereof for each Fixed Rate Term at a rate per annum equal to the LIBOR Rate for such Fixed Rate Term *plus* 1.50%; and (ii) each Prime Rate Loan shall bear interest on the outstanding principal amount thereof from the applicable borrowing date or conversion date at a fluctuating rate per annum equal to the Prime Rate.

(b) Default Rate. To the extent not prohibited by applicable laws, at any time that an Event of Default exists, all outstanding obligations hereunder shall bear interest at a fluctuating rate per annum equal to 4.0%. Accrued and unpaid interest at the Default Rate shall be due and payable upon demand.

(c) Computation and Payment. All computations of interest hereunder with respect to the Prime Rate (including any applicable interest rate margin added thereto) shall be made on the basis of a year of 365 or 366 days, as the case may be, and actual days elapsed. All other computations of interest and fees hereunder shall be made on the basis of a 360-day year, actual days elapsed. Each determination by Agent of an interest rate or fee hereunder shall be conclusive and binding for all purposes, absent manifest error.

(d) Payment Dates. Interest on each Line of Credit Advance shall be due and payable in arrears on each Interest Payment Date applicable thereto and at such other times as may be specified herein. Interest hereunder shall be due and payable in accordance with the terms hereof both before and after judgment, and both before and after the commencement of any proceeding under any Bankruptcy Law.

As used herein, the term “ Interest Payment Date ” means (a) with respect to: (i) a LIBOR Rate Loan, the last day of each Fixed Rate Term applicable thereto; *provided that*, if any such Fixed Rate Term exceeds three (3) months, the date that falls three (3) months after the beginning of such Fixed Rate Term shall also be an Interest Payment Date; and (ii) a Prime Rate Loan, the first Business Day of each calendar month.

(e) Letter of Credit Fees. (i) Borrower shall pay to Agent, for the account of each Lender in accordance with its Pro Rata Share, fees upon the issuance of each Letter of Credit equal to one and one-quarter percent (1.25%) per annum (computed on the basis of a 360-day year, actual days elapsed) of the face amount thereof, and (ii) Borrower shall pay to Agent, for the account of Letter of Credit Issuer, fees upon the payment or negotiation of each drawing under any Letter of Credit and fees upon the occurrence of any other activity with respect to any Letter of Credit (including without limitation, the transfer, amendment or cancellation of any Letter of Credit) determined in accordance with Letter of Credit Issuer's standard fees and charges then in effect for such activity.

SECTION 1.4. PAYMENTS AND PREPAYMENTS.

(a) Payments Due on Maturity Date. On the Maturity Date, Borrower shall repay to Lenders in full the aggregate Outstanding Amount of all Line of Credit Advances.

(b) Prepayments. Borrower may, upon notice to Agent, at any time or from time to time voluntarily prepay Line of Credit Advances in whole or in part without premium or penalty; *provided that*: (A) such notice must be received by Agent not later than 11:00 a.m.: (1) three (3) Business Days prior to any date of prepayment of Line of Credit Advances that are LIBOR Rate Loans; and (2) one (1) Business Day prior to the date of prepayment of Line of Credit Advances that are Prime Rate Loans; and (B) any prepayment

of any Line of Credit Advances of a given Type shall be in a principal amount of \$100,000.00 or a whole multiple of \$100,000.00 in excess thereof, or, if less, the entire principal amount thereof then outstanding. Each such notice shall specify the date and amount of such prepayment and the Type(s) of Line of Credit Advances to be prepaid. Agent will promptly notify each Lender of its receipt of each such notice and of the amount of such Lender's Pro Rata Share thereof. If Borrower gives such notice, then Borrower's prepayment obligation shall be irrevocable, and Borrower shall make such prepayment and the payment amount specified in such notice shall be due and payable on the date specified therein. Any prepayment of a Line of Credit Advance that is a LIBOR Rate Loan shall be accompanied by all accrued interest on the amount prepaid, together with any additional amounts required pursuant to **Section 1.4(c)** .

(c) LIBOR Prepayment Costs . In consideration of Lenders providing Borrower with the prepayment option included in this **Section 1.4** , or if any portion of any Line of Credit Advances shall become due and payable at any time prior to the last day of the Fixed Rate Term applicable thereto by acceleration or otherwise, Borrower shall pay to Agent, for the account of each Lender in accordance with their Pro Rata Share of the applicable Line of Credit Advance, immediately upon demand a fee which is the sum of the discounted monthly differences for each month from the month of prepayment through the month in which such Fixed Rate Term matures, calculated as follows for each month:

(i) Determine the amount of interest which would have accrued each month on the amount prepaid at the interest rate applicable to such amount had it remained outstanding until the last day of the Fixed Rate Term applicable thereto.

(ii) Subtract from the amount determined in (i) above the amount of interest which would have accrued for the same month on the amount prepaid for the remaining term of such Fixed Rate Term at LIBOR in effect on the date of prepayment for new loans made for such term and in a principal amount equal to the amount prepaid.

(iii) If the result obtained in (ii) for any month is greater than zero, discount that difference by LIBOR used in (ii) above.

Borrower acknowledges that the prepayment of such amount may result in Lenders incurring additional costs, expenses and/or liabilities, and that it is difficult to ascertain the full extent of such costs, expenses and/or liabilities. Borrower, therefore, agrees to pay the above-described prepayment fee and agrees that said amount represents a reasonable estimate of the prepayment costs, expenses and/or liabilities of Lenders. If Borrower fails to pay any prepayment fee when due, the amount of such prepayment fee shall thereafter bear interest at a rate equal to 2.0% above the Prime Rate in effect from time to time. Please refer to the LIBOR early termination prepayment example attached hereto as **Exhibit A** for illustrative purposes only.

(d) Commitment Termination . At any time (i) there is no outstanding principal balance or unpaid interest under the Line of Credit or the Letter of Credit subfeature described in **Section 1.2** above, (ii) there are no issued and outstanding Letter(s) of Credit under the Letter of Credit subfeature or any outstanding Letter of Credit Obligations, and (iii) there are no other payment obligations of Borrower to Agent or any Lender outstanding hereunder or under any other Loan Document, then Borrower, upon written notice (a "Commitment Termination Notice") to Agent and Lenders, may request that the Line of Credit be terminated with no prepayment fees.

SECTION 1.5. DEPOSIT BALANCES ARRANGEMENT. Borrower shall maintain (a) with Wells Fargo, deposit balances, calculated on a quarterly basis, not less than \$25,000,000.00 (the "Wells Fargo Minimum Balance") and (b) with Union Bank, deposit balances, calculated on a quarterly basis, not less than \$17,000,000.00 (the "Union Bank Minimum Balance") (the "Deposit Balances Arrangement").

If, for any calendar quarter during the term of the Line of Credit: (a)(i) the average daily deposit balances with Wells Fargo, *plus* (ii) Wells Fargo's Pro Rata Share of the average daily Outstanding Amount,

is less than the Wells Fargo Minimum Balance, then Borrower shall pay to Agent for the benefit of Wells Fargo, a fee calculated at a rate per annum equal to 0.25% on the amount which (i) the Wells Fargo Minimum Balance exceeds (ii) the sum of (A) the average daily deposit balances with Wells Fargo, *plus* (B) Wells Fargo's Pro Rata Share of the average daily Outstanding Amount, in each case for such calendar quarter; or (b)(i) the average daily deposit balances with Union Bank, *plus* (ii) Union Bank's Pro Rata Share of the average daily Outstanding Amount, is less than the Union Bank Minimum Balance, then Borrower shall pay to Agent for the benefit of Union Bank, a fee calculated at a rate per annum equal to 0.25% on the amount which (i) the Union Bank Minimum Balance exceeds (ii) the sum of (A) the average daily deposit balances with Union Bank, *plus* (B) Union Bank's Pro Rata Share of the average daily Outstanding Amount, in each case for such calendar quarter. The fees described in this **Section 1.5** shall be calculated on a quarterly basis by Agent and shall be due and payable by Borrower in arrears within ten (10) days after each billing is sent by Agent.

SECTION 1.6. GUARANTIES. The payment and performance of all indebtedness and other obligations of Borrower to Agent, Lenders and Letter of Credit Issuer shall be guaranteed jointly and severally by any current or hereafter created domestic subsidiaries of Borrower, as evidenced by and subject to the terms of guaranties in form and substance satisfactory to Agent, Lenders and Letter of Credit Issuer.

SECTION 1.7. PAYMENTS GENERALLY; RIGHT OF AGENT TO MAKE DEDUCTIONS AUTOMATICALLY.

(a) Payments Generally.

(i) All payments to be made by Borrower shall be made without condition or deduction for any counterclaim, defense, recoupment or setoff. Except as otherwise expressly provided herein, all payments by Borrower hereunder shall be made to Agent, for the account of the respective Lenders to which such payment is owed, at Agent's Office in Dollars and in immediately available funds not later than 12:00 noon on the date specified herein. Agent will promptly distribute to each Lender its applicable Pro Rata Share (or other applicable share as provided herein) of such payment in like funds by wire transfer to the office designated by such Lender (each, a "Lending Office"). All payments received by Agent after 12:00 noon shall be deemed received on the next succeeding Business Day and any applicable interest or fee shall continue to accrue. If any payment to be made by Borrower shall come due on a day other than a Business Day, payment shall be made on the next following Business Day, and such extension of time shall be reflected in computing interest or fees, as the case may be.

(ii) Borrower hereby authorizes Agent: (A) to deduct automatically all principal, interest or fees when due hereunder or under any note from any account of Borrower maintained with Agent; and (B) if and to the extent any payment of principal, interest or fees under this Agreement or any note is not made when due to deduct any such amount from any or all of the accounts of Borrower maintained at Agent. Agent agrees to provide written notice to Borrower of any automatic deduction made pursuant to this **Section 1.7(a)(ii)** showing in reasonable detail the amounts of such deduction. Each Lender agrees to reimburse Borrower based on its applicable Pro Rata Share for any amounts deducted from such accounts in excess of amount due hereunder and under any other Loan Documents.

(b) Fundings by Lenders, Payments by Borrower and Presumptions by Agent.

(i) Unless Agent shall have received notice from a Lender prior to the proposed date of any borrowing of a Line of Credit Advance that such Lender will not make available to Agent such Lender's share of such Line of Credit Advance, Agent may assume that such Lender has made such share available on such date in accordance with **Section 1.1(b)(iv)** and may, in reliance upon such assumption, make available to Borrower a corresponding amount. In such event, if a Lender has not in fact made its share of the applicable borrowing available to Agent, then the applicable Lender,

on the one hand, and Borrower, on the other hand, each severally agrees to pay to Agent forthwith on demand such corresponding amount in immediately available funds with interest thereon, for each day from the date such amount is made available to Borrower to the date of payment to Agent, at: (A) in the case of a payment to be made by such Lender, the greater of the Prime Rate and a rate determined by Agent in accordance with banking industry rules on interbank compensation, *plus* any administrative, processing or similar fees customarily charged by Agent in connection with the foregoing; and (B) in the case of a payment to be made by Borrower, a rate per annum equal to Prime Rate Loans. If Borrower and such Lender shall pay such interest to Agent for the same or an overlapping period, Agent shall promptly remit to Borrower the amount of such interest paid by Borrower for such period. If such Lender pays its share of the applicable borrowing to Agent, then the amount so paid shall constitute such Lender's funding of its Pro Rata Share of such borrowing. Any payment by Borrower shall be without prejudice to any claim Borrower may have against a Lender that shall have failed to make such payment to Agent.

(ii) Unless Agent shall have received notice from Borrower prior to the date on which any payment is due hereunder to Agent for the account of Lenders that Borrower will not make such payment, Agent may assume that Borrower has made such payment on such date in accordance herewith and may, in reliance upon such assumption, distribute to Lenders the amount due. In such event, if Borrower has not in fact made such payment, then Lenders each severally agrees to repay to Agent forthwith on demand the amount so distributed to such Lenders in immediately available funds with interest thereon, for each day from the date such amount is distributed to it to the date of payment to Agent, at the greater of the Prime Rate and a rate determined by Agent in accordance with banking industry rules on interbank compensation *plus* any administrative fees, costs and expenses. A notice of Agent to any Lender or Borrower with respect to any amount owing under this subsection (b) shall be conclusive, absent manifest error.

(c) Obligations of Lenders Several. The obligations of Lenders hereunder to make Line of Credit Advances, to fund participations in Letters of Credit and to make any reimbursement payments to Agent are several and not joint. The failure of any Lender to make any Line of Credit Advance, to fund any such participation or to make any reimbursement payment to Agent on any date required hereunder shall not relieve any other Lender of its corresponding obligation to do so on such date, and no Lender shall be responsible for the failure of any other Lender to so make its Line of Credit Advance, purchase its participation or to make its reimbursement payment.

(d) Funding Sources. Nothing herein shall be deemed to obligate any Lender to obtain the funds for any advance under the Line of Credit in any particular place or manner or to constitute a representation by any Lender that it has obtained or will obtain the funds for any advance under the Line of Credit in any particular place or manner.

SECTION 1.8. SHARING OF PAYMENTS. If any Lender shall, by exercising any right of setoff or counterclaim or otherwise, obtain payment in respect of any principal of or interest on any Line of Credit Advance made by it, or the participations in any Letter of Credit, resulting in such Lender receiving payment of a proportion of the aggregate amount of such advances or participations and accrued interest thereon greater than its Pro Rata Share (or other applicable share as provided herein) thereof as provided herein, then the Lender receiving such greater proportion shall: (a) notify Agent of such fact; and (b) purchase (for cash at face value) participations in the Line of Credit Advances and subparticipations in Letters of Credit of the other Lenders, or make such other adjustments as shall be equitable, so that the benefit of all such payments shall be shared by Lenders ratably in accordance with the aggregate amount of principal of and accrued interest on their respective advances under the Line of Credit and other amounts owing them; *provided* that: (i) if any such participations or subparticipations are purchased and all or any portion of the payment giving rise thereto is recovered, such participations or subparticipations shall be rescinded and the purchase price restored to the extent of such recovery, without interest; and (ii) the provisions of this **Section 1.8** shall not be construed to apply to: (A) any payment made by Borrower pursuant to and in accordance with the express terms of this Agreement; (B) any payment obtained by a Lender as

consideration for the assignment of or sale of a participation in any of its Line of Credit Advances or subparticipations in Letters of Credit to any assignee or participant, other than to Borrower or any Subsidiary thereof (as to which the provisions of this **Section 1.6** shall apply); (C) any cash collateral or other credit support provided to Agent in respect of a Defaulting Lender or Impacted Lender pursuant to **Section 1.9** or **Section 1.10** ; (D) any cash collateral or other credit support provided to Agent in respect of a Defaulting Lender or Impacted Lender; or (E) any payment made by Borrower pursuant to **Section 1.10(b)** .

SECTION 1.9. DEFAULTING LENDERS. Notwithstanding anything to the contrary contained herein, in the event that any Lender at any time is a Defaulting Lender, then: (a) during any Defaulting Lender Period with respect to such Defaulting Lender, such Defaulting Lender shall be deemed not to be a “Lender ” for purposes of voting on any matters (including the granting of any consents or waivers) with respect to any of the Loan Documents and such Defaulting Lender's Pro Rata Share of the Line of Credit shall be excluded for purposes of determining “ Required Lenders ” (*provided* that the foregoing shall not permit an increase in such Lender's Pro Rata Share of the Line of Credit or an extension of the Maturity Date without such Lender's consent); (b) to the extent permitted by applicable law, until such time as the difference between the amounts required to be advanced by such Defaulting Lender less the amount actually advanced by such Defaulting Lender shall have been reduced to zero, any voluntary prepayment of the Line of Credit shall, if Agent so directs at the time of making such voluntary prepayment, be applied to the Line of Credit Advances of other Lenders as if such Defaulting Lender had no Line of Credit Advances outstanding; (c) such Defaulting Lender's Line of Credit Advances shall be excluded for purposes of calculating any fee payable to the Lenders pursuant to **Section 1.3** in respect of any day during any Defaulting Lender Period with respect to such Defaulting Lender, and such Defaulting Lender shall not be entitled to receive any such fee payable pursuant to **Section 1.3** in respect of such Defaulting Lender Period; (d) if so requested by Agent at any time during the Defaulting Lender Period with respect to such Defaulting Lender, Borrower shall deliver to Agent cash collateral in an amount equal to such Defaulting Lender's Pro Rata Share of the Letters of Credit then outstanding; and (e) the Defaulting Lender's Pro Rata Share of any prepayment made during the Defaulting Lender Period shall be held by Agent as cash collateral for such Defaulting Lender's Pro Rata Share of the Letters of Credit then outstanding. No obligation of any Lender to make Line of Credit Advances shall be increased or otherwise affected, and, except as otherwise expressly provided in this **Section 1.9** , performance by Borrower of its obligations hereunder and the other Loan Documents shall not be excused or otherwise modified as a result of the operation of this **Section 1.9** . The rights and remedies against a Defaulting Lender under this **Section 1.10** are in addition to other rights and remedies which Borrower may have against such Defaulting Lender and which Agent or any other Lender may have against such Defaulting Lender.

As used herein, the term “ Defaulting Lender ” means any Lender that: (a) has failed to fund any portion of any Line of Credit Advance or any participations in any Letter of Credit required to be funded by it hereunder (a “ Defaulted Loan ”) within one (1) Business Day of the date required to be funded by it hereunder; (b) has otherwise failed to pay over to Agent or any other Lender, as the case may be, any other amount required to be paid by it hereunder within one (1) Business Day of the date when due, unless the subject of a good faith dispute; or (c) has been deemed insolvent or become the subject of a bankruptcy or insolvency proceeding or a receiver or conservator has been appointed for such Lender.

As used herein, the term “ Defaulting Lender Period ” means, with respect to any Defaulting Lender, the period commencing on the date upon which such Lender first became a Defaulting Lender and ending on the earliest of the following dates: (a) the date on which all obligations to make Line of Credit Advances are cancelled or terminated or all obligations of Borrower hereunder are declared or become immediately due and payable; and (b) the date on which such Defaulting Lender is no longer a Defaulting Lender.

SECTION 1.10. REPLACEMENT OF LENDERS.

(a) Replacement of Lenders Generally . Borrower may with respect to any Specified Lender:

(i) request one or more of the other Lenders to acquire and assume all of such Specified Lender's Line of Credit Advances (including participations in Letters of Credit) and Pro Rata Share of the Line of Credit, which Lender or Lenders shall have the right, but not the obligation, to so acquire and assume such Specified Lender's Line of Credit Advances (including participations in Letters of Credit) and Pro Rata Share of the Line of Credit pursuant to the procedures set forth in **Section 8.4** or

(ii) with the prior written consent of Agent, designate a replacement bank or financial institution that is an Eligible Assignee (a "Replacement Lender"), which Replacement Lender shall assume all of such Specified Lender's Line of Credit Advances (including participations in Letters of Credit) and Pro Rata Share of the Line of Credit pursuant to the procedures set forth in **Section 8.4** ;

provided that Borrower may not request such Specified Lender to make any assignment and delegation, pursuant to the immediately preceding clauses (i) or (ii), as applicable, if: (1) a Default then exists; (2) as a result of a change in circumstances involving such Lender or otherwise prior to the effectiveness of any such action, such Specified Lender is no longer a Specified Lender as a result of it no longer being a Defaulting Lender or an Impacted Lender; or (3) Borrower has not concurrently taken an action under clause (i) or clause (ii) of this **Section 1.10** with respect to all other Lenders who at the time are Specified Lenders;

Any assignment and delegation by, a Specified Lender pursuant to this **Section 1.10(a)** shall be subject to payment to such Specified Lender of the aggregate Outstanding Amount of its Line of Credit Advances (including participations in Letters of Credit) at the time owing to it, all accrued and unpaid interest thereon, all accrued and unpaid fees and all other amounts payable to it hereunder, which amounts shall be paid to such Specified Lender by the applicable assignee (to the extent of all such outstanding principal and accrued and unpaid interest and fees) and Borrower (to the extent of all such other amounts). Each Lender hereby grants to Agent a power of attorney (which power of attorney, being coupled with an interest, is irrevocable) to execute and deliver, on behalf of such Lender, as assignor, any assignment and assumption necessary to effectuate any assignment of such Lender's interests hereunder in circumstances contemplated by this **Section 1.10(a)** .

(b) Removal of Specified Lenders . Without limitation of, and in addition to, Borrower's right to replace a Lender in the circumstances and in the manner set forth in **Section 1.10(a)** , if any Lender is a Defaulting Lender or an Impacted Lender, then Borrower may, in the alternative and at its sole expense and effort, upon written notice to such Lender, Agent and Letter of Credit Issuer, require that such Lender be terminated as a Lender hereunder (a "Terminated Lender"); *provided* that:

(i) no such termination of a Terminated Lender may occur if any Letter of Credit Obligations (including Unreimbursed Amounts and undrawn availability under outstanding Letters of Credit) remain outstanding as of such the date of termination as requested by Borrower (the "Termination Date") or, if the Terminated Lender is also Letter of Credit Issuer hereunder, any Letter of Credit of such Terminating Lender, in its capacity as Letter of Credit Issuer, is outstanding hereunder;

(ii) no such termination of a Terminated Lender may occur if on the Termination Date, after giving effect to the reduction in the aggregate Commitments by the amount of the Terminated Lender's Commitments, (A) the Outstanding Amount of Line of Credit Advances shall exceed the aggregate Commitments as so reduced, or (B) the aggregate Commitments as so reduced shall exceed either the Letter of Credit Sublimit;

(iii) such Terminated Lender shall have received payment of an amount equal to all accrued fees and all other amounts payable to it hereunder and under the other Loan Documents from the Borrower;

(iv) upon the request of Letter of Credit Issuer made prior to the Termination Date, the Letter of Credit Sublimit has been reduced to the extent requested by Letter of Credit Issuer; and

(v) such termination does not conflict with applicable Laws.

provided that Borrower may not remove such Defaulting Lender or Impacted Lender pursuant to this **Section 1.10(b)** if: (1) a Default then exists or (2) as a result of a change in circumstances involving such Lender or otherwise prior to the effectiveness of any such termination, such Defaulting Lender or Impacted Lender is no longer a Defaulting Lender or an Impacted Lender.

Effective on the Termination Date, the Commitments of the Terminated Lender shall terminate, the aggregate Commitments shall thereupon equal the remaining Commitments, and the Pro Rata Share of the remaining Lenders hereunder shall be deemed to be adjusted to take into account such termination. Agent shall promptly notify the remaining Lenders and Letter of Credit Issuer of the occurrence of the Termination Date as to a Terminated Lender, the revised aggregate Commitments and the Pro Rata Shares of the Lenders hereunder, and the currently effective Letter of Credit Sublimit. For the avoidance of doubt, nothing in this **Section 1.10(b)** shall be construed as or shall increase the Commitments of any Lender hereunder, and the sole effect on the remaining Lenders shall be the foregoing adjustment in their respective Pro Rata Shares as a result of such termination.

As used herein, the term “ Specified Lender ” means, at any time, any Lender: (a) that has requested compensation under **Section 1.11** and has not rescinded such request within five (5) Business Days of the making thereof; (b) to whom Borrower must pay an additional amount (or on whose behalf Borrower must pay an additional amount to a governmental authority) pursuant to **Section 1.11** ; (c) that is a Defaulting Lender; or (d) that is a Lender that may, but does not, provide its consent to any matter as to which Required Lenders may give and have given their consent pursuant to **Section 8.5** .

As used herein, the term “ Impacted Lender ” means, with respect to any requested issuance of a Letter of Credit or any requested funding of a Swing Advance, a Defaulting Lender or a Lender as to which (a) Letter of Credit Issuer has a good faith belief that such Lender has defaulted in fulfilling its obligations under one or more other syndicated credit facilities, or (b) a person that controls such Lender has been deemed insolvent or become the subject of a bankruptcy or insolvency proceeding or a receiver or conservator has been appointed for such person.

(c) Certain Rights as a Lender . Upon the prepayment of all amounts owing to any Specified Lender and the termination of such obligations to make advances under the Line of Credit pursuant to this **Section 1.10** , such Specified Lender shall no longer constitute a “Lender” for purposes hereof; *provided* that such Specified Lender shall continue to be entitled to the benefits of **Section 8.3** with respect to facts and circumstances occurring prior to the date on which all amounts owing to such Specified Lender were prepaid in full and the obligations to make advances under the Line of Credit of such Specified Lender were terminated pursuant to this **Section 1.10** .

(d) Evidence of Replacement . Promptly following the removal or replacement of any Specified Lender in accordance with this **Section 1.10** , Agent shall distribute an amended **Schedule 1** , which shall be deemed incorporated into this Agreement, to reflect changes in the identities of Lenders and adjustments of their respective Pro Rata Shares, as applicable, resulting from any such removal or replacement.

SECTION 1.11. TAXES AND REGULATORY COSTS. Borrower shall pay to Agent, on account of the applicable Lender, immediately upon demand, in addition to any other amounts due or to become due hereunder, any and all (a) withholdings, interest, equalization taxes, stamp taxes or other taxes (except

income and franchise taxes) imposed by any domestic or foreign governmental authority and related in any manner to any Line of Credit Advance or Letter of Credit, and (b) future, supplemental, emergency or other charges, assessment rates imposed by the Federal Deposit Insurance Corporation, or similar requirements or capital or liquidity costs or requirements imposed by any domestic or foreign governmental authority or resulting from compliance by such Lender with any request or directive (whether or not having the force of law) from any central bank or other governmental authority and related in any manner to any Line of Credit Advance or Letter of Credit. In determining which of the foregoing are attributable to Borrower hereunder, any reasonable allocation made by such Lender among its operations shall be conclusive and binding upon Borrower. It is understood and agreed that any such charges, assessment rates or other costs imposed upon any Lender under (x) the Dodd–Frank Wall Street Reform and Consumer Protection Act and all requests, rules, guidelines or directives thereunder or issued in connection therewith and (y) all requests, rules, guidelines or directives promulgated by the Bank for International Settlements, the Basel Committee on Banking Supervision (or any successor or similar authority) or the United States or foreign regulatory authorities, in each case pursuant to Basel III, shall in each case be deemed to be a “future, supplemental, emergency or other charge”, regardless of the date enacted, adopted or issued.

ARTICLE II REPRESENTATIONS AND WARRANTIES

Borrower makes the following representations and warranties to Agent and each Lender:

SECTION 2.1. LEGAL STATUS. Borrower is a corporation, duly organized and existing and in good standing under the laws of Delaware, and is qualified or licensed to do business (and is in good standing as a foreign corporation, if applicable) in all jurisdictions in which such qualification or licensing is required, except in those states in which the failure to so qualify or to be so licensed could not reasonably be expected to have a material adverse effect on Borrower.

SECTION 2.2. AUTHORIZATION AND VALIDITY. This Agreement and each promissory note, contract, instrument and other document required hereby or at any time hereafter delivered to Agent or any Lender in connection herewith (collectively, the “Loan Documents”) have been duly authorized, and upon their execution and delivery in accordance with the provisions hereof will constitute legal, valid and binding agreements and obligations of Borrower or the party which executes the same, as applicable, enforceable in accordance with their respective terms.

SECTION 2.3. NO VIOLATION. The execution, delivery and performance by Borrower of each of the Loan Documents do not violate any provision of any law or regulation, or contravene any provision of the Certificate of Incorporation or By-Laws of Borrower, or result in any breach of or default under any contract, obligation, indenture or other instrument to which Borrower is a party or by which Borrower may be bound, except where such violation, contravention, breach or default would not reasonably be expected to have a material adverse effect on Borrower.

SECTION 2.4. LITIGATION. There are no pending, or to Borrower's knowledge threatened in writing, actions, claims, investigations, suits or proceedings by or before any governmental authority, arbitrator, court or administrative agency involving more than \$1,000,000 individually, or \$10,000,000 in the aggregate, or which would reasonably be expected to have a material adverse effect on the financial condition or operation of Borrower other than those disclosed by Borrower to Agent in writing or in Borrower's periodic and other reports, proxy statements and other materials filed with the SEC or distributed to its stockholders (the “SEC Filings”) prior to the date hereof. As used in this Agreement, “SEC” means the Securities and Exchange Commission, any entity succeeding to any or all of the functions of the Securities and Exchange Commission or any national securities exchange or analogous agency, authority, instrumentality, regulatory body, court or other entity.

SECTION 2.5. CORRECTNESS OF FINANCIAL STATEMENT. The annual financial statement of Borrower dated December 31, 2011, and all interim financial statements delivered to Agent since said date,

true copies of which have been delivered by Borrower to Agent prior to the date hereof, (a) are complete and correct in all material aspects and present fairly the financial condition of Borrower, (b) disclose all liabilities of Borrower that are required to be reflected or reserved against under generally accepted accounting principles, whether liquidated or unliquidated, fixed or contingent, and (c) have been prepared in accordance with generally accepted accounting principles consistently applied. Other than for Permitted Liens, Borrower has not mortgaged, pledged, granted a security interest in or otherwise encumbered any of its assets or properties except in favor of Agent or as otherwise permitted by Agent in writing.

As used herein, the term “ Permitted Liens ” means (i) Liens for taxes or other governmental or regulatory assessments which are not delinquent, or which are contested in good faith by the appropriate proceedings, and for which appropriate reserves are maintained in accordance with GAAP; (ii) Liens on any property held or acquired by Borrower securing indebtedness not to exceed the amounts set forth in **Section 5.2(c)** below incurred or assumed for the purpose of financing all or any part of the cost of acquiring such property or existing on such property when acquired; (iii) liens arising from judgments, decrees or attachments in circumstances not constituting an Event of Default (iv) liens and setoff rights in favor of other financial institutions arising in connection with Borrower's deposit accounts held at such institutions, *provided* the existence of such accounts does not conflict with the provisions of **Section 4.9(c)** hereof, (v) liens incurred or deposits made in the ordinary course of business in connection with workers' compensation, unemployment insurance and other types of social security, (vi) liens incurred or deposits made in the ordinary course of business with utility companies, (vii) liens incurred or deposits or pledges made to secure the performance of bids, tenders, contracts (other than contracts for the payment of money), public or statutory or regulatory obligations, surety, stay, appeal, indemnity, performance or other similar bonds, leases, government contracts, trade contracts, performance and return-of-money bonds and other similar obligations arising in the ordinary course of business (viii) materialmen's, landlord's, mechanics', repairmen's, workmen's, employees' or other like liens arising in the ordinary course of business, (ix) non-exclusive license of intellectual property granted to third parties in the ordinary course of business, and licenses of intellectual property that could not result in a legal transfer of title of the licensed property that may be exclusive in respects other than territory and that may be exclusive as to territory only as to discrete geographical areas outside of the United States, (x) liens on insurance proceeds in favor of insurance companies granted solely as security for financed premiums, (xi) easements, reservations, rights-of-way, minor defects or irregularities in title and other similar charges or encumbrances affecting real property, and (xii) any interest or title of a lessor or sub-lessor under any lease of real property in the ordinary course of business.

SECTION 2.6. INCOME TAX RETURNS. Borrower has no knowledge of any pending assessments or adjustments of its income tax payable with respect to any year, except as disclosed in SEC reporting.

SECTION 2.7. NO SUBORDINATION. There is no agreement, indenture, contract or instrument to which Borrower is a party or by which Borrower may be bound that requires the subordination in right of payment of any of Borrower's obligations subject to this Agreement to any other obligation of Borrower.

SECTION 2.8. PERMITS, FRANCHISES. Borrower possesses, and will hereafter possess, all permits, consents, approvals, franchises and licenses required and rights to all trademarks, trade names, patents, and fictitious names, if any, necessary to enable it to conduct the business in which it is now engaged in compliance with applicable law.

SECTION 2.9. ERISA. Borrower is in compliance in all material respects with all applicable provisions of the Employee Retirement Income Security Act of 1974, as amended or recodified from time to time (“ ERISA ”); Borrower has not violated any provision of any defined employee pension benefit plan (as defined in ERISA) maintained or contributed to by Borrower (each, a “ Plan ”); no Reportable Event as defined in ERISA has occurred and is continuing with respect to any Plan initiated by Borrower; Borrower has met its minimum funding requirements under ERISA with respect to each Plan; and each Plan will be able to fulfill its benefit obligations as they come due in accordance with the Plan documents and under generally accepted

accounting principles.

SECTION 2.10. OTHER OBLIGATIONS. Borrower is not in default on any obligation for borrowed money, any purchase money obligation or any other material lease, commitment, contract, instrument or obligation, in each case under any agreements involving monetary liability, which default or defaults result in a right by such third party or parties, whether or not exercised, to accelerate the maturity of any indebtedness in excess of Five Million Dollars (\$5,000,000).

SECTION 2.11. ENVIRONMENTAL MATTERS. Except as disclosed by Borrower to Agent in writing prior to the date hereof, Borrower is in compliance in all material respects with all applicable federal or state environmental, hazardous waste, health and safety statutes, and any rules or regulations adopted pursuant thereto, which govern or affect any of Borrower's operations and/or properties, including without limitation, the Comprehensive Environmental Response, Compensation and Liability Act of 1980, the Superfund Amendments and Reauthorization Act of 1986, the Federal Resource Conservation and Recovery Act of 1976, and the Federal Toxic Substances Control Act, as any of the same may be amended, modified or supplemented from time to time. None of the operations of Borrower is the subject of any federal or state investigation evaluating whether any remedial action involving a material expenditure is needed to respond to a release of any toxic or hazardous waste or substance into the environment. Borrower has no material contingent liability in connection with any release of any toxic or hazardous waste or substance into the environment.

SECTION 2.12. MARGIN STOCK. Neither Borrower nor any subsidiary thereof is engaged principally or as one of its activities in the business of extending credit for the purpose of "purchasing" or "carrying" any "margin stock" (as each such term is defined or used, directly or indirectly, in Regulation U of the Board of Governors of the Federal Reserve System). No part of the proceeds of any of the Line of Credit Advances or Letters of Credit will be used for purchasing or carrying margin stock or for any purpose which violates, or which would be inconsistent with, the provisions of Regulation T, U or X of such Board of Governors. Following the application of the proceeds of each Line of Credit Advance or Letter of Credit, not more than twenty-five percent (25%) of the value of the assets (either of Borrower only or of Borrower and its subsidiaries on a Consolidated basis) will be "margin stock". If requested by any Lender (through Agent) or Agent, Borrower will furnish to Agent and each Lender a statement to the foregoing effect in conformity with the requirements of FR Form G-3 or FR Form U 1 referred to in Regulation U.

ARTICLE III CONDITIONS

SECTION 3.1. CONDITIONS OF INITIAL EXTENSION OF CREDIT. The obligation of Lenders and Letter of Credit Issuer to extend any credit contemplated by this Agreement is subject to the fulfillment to Agent, each Lender and Letter of Credit Issuer's satisfaction of all of the following conditions:

(a) Approval of Counsel. All legal matters incidental to the extension of credit by Lenders shall be satisfactory to Agent's counsel.

(b) Documentation. Agent shall have received, in form and substance satisfactory to Agent, Lenders and Letter of Credit Issuer, each of the following, duly executed:

- (i) This Agreement and each promissory note or other instrument or document required hereby.
- (ii) Corporate Resolution: Borrowing.
- (iii) Certificate of Incumbency.
- (iv) Disbursement Order.
- (v) Such other documents as Agent or any Lender may require under any other Section of this Agreement, including a Letter of Credit application.

(c) Financial Condition. There shall have been no material adverse change, as determined by Agent and Lenders, in the financial condition or business of Borrower or any guarantor hereunder, nor any material decline, as determined by Agent and Lenders, in the market value of any collateral required hereunder or a substantial or material portion of the assets of Borrower or any such guarantor.

(d) Insurance. Borrower shall have delivered to Agent evidence of insurance coverage on all Borrower's property, in form, substance, amounts, covering risks and issued by companies satisfactory to Agent, and where required by Agent, with loss payable endorsements in favor of Agent.

SECTION 3.2. CONDITIONS OF EACH EXTENSION OF CREDIT. The obligation of Agent and Lenders to make each extension of credit requested by Borrower hereunder shall be subject to the fulfillment to Agent's and each Lender's satisfaction of each of the following conditions:

(a) Compliance. The representations and warranties contained herein and in each of the other Loan Documents shall be true on and as of the date of the signing of this Agreement and, except as disclosed to Agent or in the SEC Filings, on the date of each extension of credit by any Lender or Letter of Credit Issuer pursuant hereto, with the same effect as though such representations and warranties had been made on and as of each such date, and on each such date, no Default or Event of Default, shall have occurred and be continuing or shall exist.

(b) Documentation. Agent shall have received all additional documents which may be required in connection with such extension of credit.

(c) Additional Letter of Credit Documentation. Prior to the issuance of each Letter of Credit, Letter of Credit Issuer shall have received a Letter of Credit Agreement on Letter of Credit Issuer's standard form, properly completed and duly executed by Borrower.

(d) No Material Adverse Change. There shall not exist or have occurred any event or condition that impairs, or is substantially to impair, the prospect of payment or performance by Borrower of its obligations under any of the Loan Documents.

ARTICLE IV AFFIRMATIVE COVENANTS

Borrower covenants that so long as any Lender or Letter of Credit Issuer remains committed to extend credit to Borrower pursuant hereto, or any liabilities (whether direct or contingent, liquidated or unliquidated) of Borrower to Agent, any Lender or Letter of Credit Issuer under any of the Loan Documents remain outstanding, and until payment in full of all obligations (other than inchoate indemnity obligations) of Borrower subject hereto, Borrower shall, unless Required Lenders otherwise consent in writing:

SECTION 4.1. PUNCTUAL PAYMENTS. Within seven (7) days after such obligations are due and payable, pay all principal, interest, fees or other liabilities due under any of the Loan Documents at the times and place and in the manner specified therein.

SECTION 4.2. ACCOUNTING RECORDS. Maintain adequate books and records in accordance with generally accepted accounting principles consistently applied, and permit any representative of Agent, at any reasonable time, to inspect, audit and examine such books and records, to make copies of the same, and to inspect the properties of Borrower.

SECTION 4.3. FINANCIAL STATEMENTS. Provide to Agent in sufficient number of copies for the delivery to each Lender all of the following, in form and detail satisfactory to Agent and Required Lenders:

(a) not later than 120 days after and as of the end of each fiscal year, an audited financial statement of Borrower, prepared by a certified public accountant acceptable to Required Lenders, to include

balance sheet, income statement, and statement of cash flow;

(b) not later than 45 days after and as of the end of each fiscal quarter, a financial statement of Borrower, prepared by Borrower, to include balance sheet, income statement, and statement of cash flow;

(c) not later than 90 days after the end of each fiscal year, an annual budget and projection report, prepared by Borrower;

(d) contemporaneously with each fiscal quarter financial statement of Borrower required hereby, a certificate of the president or chief financial officer of Borrower that said financial statements are accurate and that there exists no Default or Event of Default;

(e) concurrently with the submission of each request for a Line of Credit Advance or issuance of a Letter of Credit, a certificate of the president or chief financial officer of Borrower that the financial statements referred to in **Section 4.3(d)** are accurate, that there exists no Default or Event of Default; and

(f) from time to time such other information as Agent or Required Lenders may reasonably request.

SECTION 4.4. COMPLIANCE. Preserve and maintain all licenses, permits, governmental approvals, rights, privileges and franchises necessary for the conduct of its business; and comply with the provisions of all documents pursuant to which Borrower is organized and/or which govern Borrower's continued existence and with the requirements of all laws, rules, regulations and orders of any governmental authority applicable to Borrower and/or its business, the noncompliance with or violation of which could reasonably be expected to have a material adverse effect on Borrower's business.

SECTION 4.5. INSURANCE. Maintain and keep in force, for each business in which Borrower is engaged, insurance of the types and in amounts customarily carried in similar lines of business, including but not limited to fire, extended coverage, public liability, flood, property damage and workers' compensation, with all such insurance carried with companies and in amounts satisfactory to Required Lenders, and deliver to Agent from time to time at Required Lenders' request schedules setting forth all insurance then in effect.

SECTION 4.6. FACILITIES. Keep all properties necessary to Borrower's business in good repair and condition, and from time to time make necessary repairs, renewals and replacements thereto so that such properties shall be fully and efficiently preserved and maintained.

SECTION 4.7. TAXES AND OTHER LIABILITIES. Pay and discharge when due any and all indebtedness, obligations, assessments and taxes, both real or personal, including without limitation federal and state income taxes and state and local property taxes and assessments, except (a) such as Borrower may in good faith contest or as to which a bona fide dispute may arise, and (b) for which Borrower has made provision with adequate reserves under GAAP for eventual payment thereof in the event Borrower is obligated to make such payment.

SECTION 4.8. LITIGATION. Except as disclosed in Borrower's SEC Filings, promptly give notice in writing to Agent of any litigation pending or threatened in writing against Borrower involving more than \$1,000,000 individually, or \$10,000,000 in the aggregate.

SECTION 4.9. FINANCIAL CONDITION. Maintain Borrower's financial condition as follows using generally accepted accounting principles consistently applied and used consistently with prior practices (except to the extent modified by the definitions herein):

(a) Modified Quick Ratio not less than 1.05 to 1.00 at all times, measured on a consolidated basis at each fiscal quarter end.

As used herein, the term “ Modified Quick Ratio ” means the aggregate of consolidated unrestricted cash, unrestricted short-term and long-term marketable securities and net accounts receivable of Borrower and its subsidiaries *divided* by total current liabilities and borrowings under the Line of Credit (including, without limitation, all Line of Credit Advances).

(b) Funded Debt to Adjusted EBITDA not greater than 2.00 to 1.00 at all times, measured quarterly using trailing 12 months EBITDA.

As used herein, “ Funded Debt ” means, as of any date of determination, with respect to Borrower and its subsidiaries on a consolidated basis, determined in accordance with GAAP, the outstanding principal amount of all indebtedness owing by Borrower and its subsidiaries, whether current or long-term, including, without limitation, the obligations under this Agreement and all obligations evidenced by notes, loan agreements or other similar instruments, bonds, debentures, reimbursement agreements, bankers' acceptances, bank guaranties, capital leases, synthetic leases, surety bonds and similar instruments and the maximum drawing amount of all standby and commercial letters of credit outstanding (other than any standby or commercial letters of credit to the extent that they are cash collateralized). If, at any time, any change in GAAP would affect the definition of Funded Debt and either the Borrower or the Required Lenders shall so request, the Administrative Agent, the Lenders and the Borrower shall negotiate in good faith to amend such ratio or requirements to preserve the original intent thereof in light of such change in GAAP (subject to the approval of the Required Lenders); provided that, until so amended, (i) such ratio or requirement shall continue to be computed in accordance with GAAP prior to such change therein and (ii) the Borrower shall provide to the Administrative Agent and the Lenders financial statements and other documents required under this Agreement or as reasonably requested hereunder setting forth a reconciliation between calculations of such ratio or requirement made before and after giving effect to such change in GAAP.

As used herein, the term “ Adjusted EBITDA ” means, for any period, with respect to Borrower and its subsidiaries Consolidated Net Income, *minus* without duplication and to the extent included in determining such Consolidated Net Income, extraordinary or other non-recurring non-cash gains and interest income *plus* , without duplication and to the extent excluded in determining such Consolidated Net Income, (i) extraordinary or other non-recurring non-cash losses, including any non-cash charges for stock-based compensation expenses and impairment of intangibles, (ii) consolidated interest expense, (iii) income taxes, (iv) depreciation and amortization, (v) amortization of acquired inventory write-up to fair market value in accordance with GAAP, and (vi) expenses incurred in connection with certain one-time events as may in the future occur, subject to the mutual agreement of Borrower and Required Lenders, in each case for such period, as determined in accordance with GAAP.

As used herein, the term “ Consolidated Net Income ” means, for any specified period, the net income or loss of Borrower and its subsidiaries determined for such period on a consolidated basis in accordance with GAAP.

(c) Maintain Borrower's primary collection and disbursement deposit account(s) with Wells Fargo or any banking affiliate of Wells Fargo.

SECTION 4.10. NOTICE TO AGENT. Promptly (but in no event more than five (5) days after the occurrence of each such event or matter) give written notice to Agent in reasonable detail of: (a) the occurrence of any Default or Event of Default; (b) any change in the name or the organizational structure of Borrower; (c) the occurrence and nature of any Reportable Event or Prohibited Transaction, each as defined in ERISA, or any funding deficiency with respect to any Plan; or (d) any termination or cancellation of any insurance policy which Borrower is required to maintain, or any uninsured or partially uninsured loss through liability or property damage, or through fire, theft or any other cause affecting Borrower's property.

ARTICLE V
NEGATIVE COVENANTS

Borrower further covenants that so long as any Lender or Letter of Credit Issuer remains committed to extend credit to Borrower pursuant hereto, or any liabilities (whether direct or contingent, liquidated or unliquidated, but excluding inchoate indemnity obligations) of Borrower to Agent, any Lender or Letter of Credit Issuer under any of the Loan Documents remain outstanding, and until payment in full of all obligations (other than inchoate indemnity obligations) of Borrower subject hereto, Borrower shall not without Agent and Required Lenders' prior written consent:

SECTION 5.1. USE OF FUNDS. Use any of the proceeds of any credit extended hereunder except for the purposes stated in Article I hereof.

SECTION 5.2. OTHER INDEBTEDNESS. Create, incur, assume or permit to exist any indebtedness or liabilities resulting from borrowings, loans or advances, whether secured or unsecured, matured or unmatured, liquidated or unliquidated, joint or several, except (a) the liabilities of Borrower to Agent and Lenders under the Loan Documents, (b) any other liabilities of Borrower existing as of, and disclosed to Agent and Lenders prior to, the Closing Date, (c) new purchase money debt and other term debt in amounts not to exceed an aggregate of \$20,000,000.00 at any time (*provided* that, for the avoidance of doubt, this Section 5.2(c) shall not permit to exist any revolving or working capital debt other than the liabilities of Borrower to Agent and Lenders under the Loan Documents), (d) the issuance of unsecured, subordinated convertible debt, *provided* , however, that such debt is subordinated in writing on terms reasonably acceptable to Required Lenders and that Borrower is in proforma compliance with financial covenants both pre and post issuance of debt, (e) indebtedness to trade creditors incurred in the ordinary course of business, (f) indebtedness incurred as a result of endorsing negotiable instruments received in the ordinary course of business, (g) indebtedness secured by Permitted Liens, (h) indebtedness between Borrower and its subsidiaries in the ordinary course of business, and (h) extensions, refinancings, modifications and restatements of the foregoing provided that the principal amount thereof is not increased or the terms thereof are not modified to impose more burdensome terms.

SECTION 5.3. MERGER, CONSOLIDATION, TRANSFER OF ASSETS. Borrower may enter into mergers or acquisitions with, and make loans or advances to and equity investments in, and sell, lease or transfer assets to third party entities so long as Borrower is the surviving entity (as applicable) and Borrower is in pro forma compliance with financial covenants both before and after each such merger, consolidation, acquisition, loan, advance, equity investment, sale, lease or transfer of assets.

SECTION 5.4. GUARANTIES. Guarantee or become liable in any way as surety, endorser (other than as endorser of negotiable instruments for deposit or collection in the ordinary course of business), accommodation endorser or otherwise for, nor pledge or hypothecate any assets of Borrower as security for, any liabilities or obligations of any other person or entity, except (i) any of the foregoing in favor of Agent and Lenders pursuant to the Loan Documents, and (ii) in the ordinary course of Borrower's business.

SECTION 5.5. LOANS, ADVANCES, INVESTMENTS. Make any loans or advances to or investments in any person or entity, except (a) any of the foregoing existing as of, and disclosed to Agent and Lenders prior to, the date hereof, (b) any of the foregoing in accordance with the provisions of **Section 5.3** above, (c) additional loans, advances or investments in or to Borrower's subsidiaries in the ordinary course of business, or (d) investments made pursuant to a Board-approved investment policy.

SECTION 5.6. PLEDGE OF ASSETS. Other than for Permitted Liens, mortgage, pledge, grant or permit to exist a security interest in, or lien upon, all or any portion of Borrower's assets now owned or hereafter acquired, except any of the foregoing in favor of Agent and Lenders pursuant to the Loan Documents or which is existing as of, and disclosed to Agent and Lenders in writing prior to, the date hereof.

ARTICLE VI
EVENTS OF DEFAULT

SECTION 6.1. The occurrence of any of the following shall constitute an “Event of Default” under this Agreement:

(a) Borrower shall fail to pay, within seven (7) days of when due, any principal, interest, fees or other amounts payable under any of the Loan Documents (*provided* that such seven (7) day cure period shall not apply to payments due upon the Maturity Date and that during the cure period, the failure to make or pay any payment specified under this subclause (a) is not an Event of Default, but no credit extension will be made during the cure period).

(b) Any financial statement or certificate furnished to Agent or Lenders in connection with, or any representation or warranty made by Borrower or any other party under this Agreement or any other Loan Document shall prove to be incorrect, false or misleading in any material respect when furnished or made.

(c) Any default in the performance of or compliance with any obligation, agreement or other provision contained herein or in any other Loan Document (other than those specifically described as an “Event of Default” in this **Section 6.1**), and with respect to any such default that by its nature can be cured, such default shall continue for a period of thirty (30) days from its occurrence.

(d) Any default in the payment or performance of any monetary obligation in excess of \$5,000,000, or any defined event of default, under the terms of any contract, instrument or document (other than any of the Loan Documents) pursuant to which Borrower or any guarantor hereunder (with each such guarantor referred to herein as a “Third Party Obligor”) has incurred any debt for borrowed money in an amount greater than \$5,000,000.

(e) Borrower or any Third Party Obligor shall become insolvent, or shall suffer or consent to or apply for the appointment of a receiver, trustee, custodian or liquidator of itself or any of its property, or shall generally fail to pay its debts as they become due, or shall make a general assignment for the benefit of creditors; Borrower or any Third Party Obligor shall file a voluntary petition in bankruptcy, or seeking reorganization, in order to effect a plan or other arrangement with creditors or any other relief under the Bankruptcy Reform Act, Title 11 of the United States Code, as amended or recodified from time to time (“Bankruptcy Code”), or under any state or federal law granting relief to debtors, whether now or hereafter in effect; or Borrower or any Third Party Obligor shall file an answer admitting the jurisdiction of the court and the material allegations of any involuntary petition; or Borrower or any Third Party Obligor shall be adjudicated a bankrupt, or an order for relief shall be entered against Borrower or any Third Party Obligor by any court of competent jurisdiction under the Bankruptcy Code or any other applicable state or federal law relating to bankruptcy, reorganization or other relief for debtors (collectively, “Bankruptcy Laws”).

(f) The filing of a notice of judgment lien against Borrower in an amount of at least \$5,000,000 (not covered by independent third-party insurance as to which liability has been accepted by such insurance carrier) shall remain unsatisfied for thirty (30) days and is not discharged or stayed (whether through the posting of a bond or otherwise) within thirty (30) days; or the recording of any abstract of judgment against Borrower in an amount of at least \$5,000,000 (not covered by independent third-party insurance as to which liability has been accepted by such insurance carrier) and the same is not, within thirty (30) days after the occurrence thereof, discharged or stayed (whether through the posting of a bond or otherwise) in any county in which Borrower has an interest in real property; or the service of a notice of levy and/or of a writ of attachment or execution, or other like process, against the assets of Borrower and the same is not, within thirty (30) days after the occurrence thereof, discharged or stayed (whether through the posting of a bond or otherwise); or the entry of one or more final judgments, orders, or decrees for the payment of money in an amount, individually or in the aggregate, of at least \$5,000,000 (not covered by independent third-party insurance as to which liability has been accepted by such insurance carrier) shall be rendered against

Borrower and the same are not, within thirty (30) days after the entry thereof, discharged or execution thereof stayed or bonded pending appeal, or such judgments are not discharged prior to the expiration of any such stay; or any involuntary petition or proceeding pursuant to the Bankruptcy Code or any other applicable state or federal law relating to bankruptcy, reorganization or other relief for debtors is filed or commenced against Borrower or any Third Party Obligor.

(g) [Intentionally Omitted].

(h) The dissolution or liquidation of Borrower or any Third Party Obligor if a corporation, partnership, joint venture or other type of entity; or Borrower or any such Third Party Obligor, or any of its directors, stockholders or members, shall take action seeking to effect the dissolution or liquidation of Borrower or such Third Party Obligor.

(i) 60 days after the occurrence of any Change in Control of Borrower, coupled with removal or departure of Balu Balakrishnan as Chief Executive Officer.

As used herein, the term “ Change in Control ” means the occurrence, in a single transaction or in a series of related transactions, of any one or more of the following events:

(i) any Exchange Act Person becomes the Owner, directly or indirectly, of securities of the Borrower representing more than fifty percent (50%) of the combined voting power of the Borrower's then outstanding securities other than by virtue of a merger, consolidation or similar transaction. Notwithstanding the foregoing, a Change in Control shall not be deemed to occur (A) on account of the acquisition of securities of the Borrower directly from the Borrower, (B) on account of the acquisition of securities of the Borrower by an investor, any affiliate thereof or any other Exchange Act Person that acquires the Borrower's securities in a transaction or series of related transactions the primary purpose of which is to obtain financing for the Borrower through the issuance of equity securities, or (C) solely because the level of Ownership held by any Exchange Act Person (the “ Subject Person ”) exceeds the designated percentage threshold of the outstanding voting securities as a result of a repurchase or other acquisition of voting securities by the Borrower reducing the number of shares outstanding, *provided* that if a Change in Control would occur (but for the operation of this sentence) as a result of the acquisition of voting securities by the Borrower, and after such share acquisition, the Subject Person becomes the Owner of any additional voting securities that, assuming the repurchase or other acquisition had not occurred, increases the percentage of the then outstanding voting securities Owned by the Subject Person over the designated percentage threshold, then a Change in Control shall be deemed to occur; or

(ii) there is consummated a merger, consolidation or similar transaction involving (directly or indirectly) the Borrower and, immediately after the consummation of such merger, consolidation or similar transaction, the stockholders of the Borrower immediately prior thereto do not Own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving corporation, partnership, limited liability company or other entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving corporation, partnership, limited liability company or other entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their Ownership of the outstanding voting securities of the Borrower immediately prior to such transaction.

As used herein, the term “ Exchange Act Person ” means any natural person, corporation, partnership, limited liability company or other entity, or “group” (within the meaning of Section 13(d) or 14(d) of the Securities Exchange Act of 1934 (the “ Exchange Act ”)), except that “ Exchange Act Person ” shall not include (i) the Borrower or any subsidiary of the Borrower, (ii) any employee benefit plan of the Borrower or any subsidiary of the Borrower or any trustee or other fiduciary holding securities under an employee benefit plan of the Borrower or any subsidiary of the Borrower, (iii) an underwriter temporarily holding

securities pursuant to a registered public offering of such securities, (iv) a corporation, partnership, limited liability company or other entity Owned, directly or indirectly, by the stockholders of the Borrower in substantially the same proportions as their Ownership of stock of the Borrower; or (v) any natural person, corporation, partnership, limited liability company or other entity or "group" (within the meaning of Section 13(d) or 14(d) of the Exchange Act) that, as of the date hereof, is the Owner, directly or indirectly, of securities of the Borrower representing more than fifty percent (50%) of the combined voting power of the Borrower's then outstanding securities.

A person or corporation, partnership, limited liability company or other entity shall be deemed to "Own," to have "Owned," to be the "Owner" of, or to have acquired "Ownership" of securities if such person or corporation, partnership, limited liability company, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting power, which includes the power to vote or to direct the voting, with respect to such securities.

SECTION 6.2. REMEDIES. Upon the occurrence of any Event of Default: (a) all indebtedness of Borrower under each of the Loan Documents, any term thereof to the contrary notwithstanding, shall at Required Lenders' option and without notice become immediately due and payable without presentment, demand, protest or notice of dishonor, all of which are hereby expressly waived by Borrower; (b) the obligation, if any, of any Lender or Letter of Credit Issuer to extend any further credit under any of the Loan Documents shall immediately cease and terminate; and (c) Agent and Lenders shall have all rights, powers and remedies available under each of the Loan Documents, or accorded by law, including without limitation the right to resort to any or all security for any credit subject hereto and to exercise any or all of the rights of a beneficiary or secured party pursuant to applicable law. All rights, powers and remedies of Agent shall, the request of, or may, with the consent of, Required Lenders, be exercised at any time by Agent and from time to time after the occurrence of an Event of Default, are cumulative and not exclusive, and shall be in addition to any other rights, powers or remedies provided by law or equity.

ARTICLE VII AGENT

SECTION 7.1. APPOINTMENT AND AUTHORIZATION OF AGENT. Each Lender hereby irrevocably appoints Wells Fargo to act on its behalf as Agent hereunder and under the other Loan Documents and authorizes Agent to take such actions on its behalf and to exercise such powers as are delegated to Agent by the terms hereof and thereof, together with such actions and powers as are reasonably incidental thereto. The provisions of this Article VII are solely for the benefit of Agent and Lenders, and Borrower shall not have rights as a third party beneficiary of any of such provisions.

SECTION 7.2. RIGHTS AS A LENDER. If the person serving as Agent hereunder is also a "Lender," such person shall have the same rights and powers in such capacity as any other person in such capacity and may exercise the same as though it were not Agent. Such person and its affiliates may accept deposits from, lend money to, act as the financial advisor or in any other advisory capacity for and generally engage in any kind of business with Borrower or any subsidiary or affiliate of borrower as if such person were not Agent hereunder and without any duty to account therefor to any Lender.

SECTION 7.3. EXCULPATORY PROVISIONS. Agent shall not have any duties or obligations except those expressly set forth herein and in the other Loan Documents. Without limiting the generality of the foregoing, Agent:

(a) No Fiduciary Duties. Shall not be subject to any fiduciary or other implied duties, regardless of whether a Default has occurred and is continuing;

(b) No Obligations Regarding Certain Actions. Shall not have any duty to take any discretionary action or exercise any discretionary powers, except discretionary rights and powers expressly contemplated

hereby or by the other Loan Documents that Agent is required to exercise as directed in writing by Required Lenders (or such other number or percentage of Lenders as shall be expressly provided for herein or in any other Loan Documents, as applicable; *provided* that Agent shall not be required to take any action that, in its opinion or the opinion of its counsel, may expose Agent to liability or that is contrary to any Loan Document or applicable laws;

(c) Disclosure Obligations. Shall not, except as expressly set forth herein and in the other Loan Documents, have any duty to disclose, and shall not be liable for the failure to disclose, any information relating to Borrower or any of its affiliates that is communicated to or obtained by the person serving as Agent or any of its affiliates in any capacity; and

(d) Limitation on Liability. Shall not be liable for any action taken or not taken by it: (i) with the consent or at the request of Required Lenders (or such other number or percentage of Lenders as shall be necessary, or as Agent shall believe in good faith shall be necessary, under the circumstances as provided in **Section 6.2** and **Section 8.5**); or (ii) in the absence of its own gross negligence or willful misconduct. Agent shall be deemed not to have knowledge of any Default, unless and until Borrower or a Lender provides written notice to Agent describing such Default. Agent shall not be responsible for or have any duty to ascertain or inquire into: (A) any statement, warranty or representation made in or in connection with this Agreement or any other Loan Document; (B) the contents of any certificate, report or other document delivered hereunder or thereunder or in connection herewith or therewith; (C) the performance or observance of any of the covenants, agreements or other terms or conditions set forth herein or therein or the occurrence of any Default; (D) the validity, enforceability, effectiveness or genuineness of this Agreement, any other Loan Document or any other agreement, instrument or document; or (E) the satisfaction of any condition set forth in Article III or elsewhere herein, other than to confirm receipt of items expressly required to be delivered to Agent.

SECTION 7.4. RELIANCE BY AGENT. Agent shall be entitled to rely upon, and shall not incur any liability for relying upon, any notice, request, certificate, consent, statement, instrument, document or other writing (including any electronic message, Internet or intranet website posting or other distribution) believed by it to be genuine and to have been signed, sent or otherwise authenticated by the proper person. Agent also may rely upon any statement made to it orally or by telephone and believed by it to have been made by the proper person and shall not incur any liability for relying thereon. In determining compliance with any condition hereunder to the making of a Line of Credit Advance, or the issuance of a Letter of Credit, that by its terms must be fulfilled to the satisfaction of a specified Lender, Agent may presume that such condition is satisfactory to such Lender, unless Agent shall have received notice to the contrary from such Lender prior to the making of such Line of Credit Advance, or the issuance of such Letter of Credit. Agent may consult with legal counsel (who may be counsel for Borrower), independent accountants and other experts it selects and shall not be liable for any action it takes or does not take in accordance with the advice of any such counsel, accountants or experts.

SECTION 7.5. DELEGATION OF DUTIES. Agent may perform any and all of its duties and exercise its rights and powers hereunder or under any other Loan Document by or through any one or more sub-agents it appoints. Agent and any such sub-agent may perform any and all of its duties and exercise its rights and powers by or through their respective related parties. The exculpatory provisions of this Article VII shall apply to any such sub-agent and to the related parties of Agent and any such sub-agent and shall apply to their respective activities in connection with the syndication of the credit facilities provided for herein, as well as activities as Agent.

SECTION 7.6. RESIGNATION OF AGENT. Agent may at any time give notice of its resignation to Lenders and Borrower. Upon receipt of any such notice of resignation, Required Lenders shall have the right, with, unless an Event of Default exists, the consent of Borrower (which consent shall not be unreasonably withheld), to appoint a successor, which shall be a bank with an office in the United States, or an affiliate of any such bank with an office in the United States. If no such successor shall have been so appointed by Required Lenders and shall have accepted such appointment within thirty (30) days after the

retiring Agent gives notice of its resignation, then the retiring Agent may on behalf of Lenders, appoint a successor Agent meeting the qualifications set forth in this **Section 7.6** ; *provided that*, if Agent shall notify Lenders and Borrower that no qualifying person has accepted such appointment, then such resignation shall nonetheless become effective in accordance with such notice and (a) the retiring Agent shall be discharged from its duties and obligations hereunder and under the other Loan Documents (except that in the case of any collateral security held by Agent on behalf of any Lender under any of the Loan Documents, the retiring Agent shall continue to hold such collateral security until such time as a successor Agent is appointed) and (b) all payments, communications and determinations provided to be made by, to or through Agent shall instead be made by or to each Lender directly, until such time as Required Lenders appoint a successor Agent as provided for in this **Section 7.6** . Upon the acceptance of a successor's appointment as Agent hereunder, such successor shall succeed to and become vested with all of the rights, powers, privileges and duties of the retiring (or retired) Agent, and the retiring Agent shall be discharged from all of its duties and obligations hereunder or under the other Loan Documents (if not already discharged therefrom as provided in this **Section 7.6**). The fees payable by Borrower to a successor Agent shall be the same as those payable to its predecessor unless otherwise agreed between Borrower and such successor. After the retiring Agent's resignation hereunder and under the other Loan Documents, the provisions of this Article VII and **Section 8.3** shall continue in effect for the benefit of such retiring Agent, its sub-agents and their respective related parties in respect of any actions taken or omitted to be taken by any of them while the retiring Agent was acting as Agent.

Any resignation by Wells Fargo as Agent pursuant to this **Section 7.6** shall also constitute its resignation as Letter of Credit Issuer. Upon the acceptance of a successor's appointment as Agent hereunder: (i) such successor shall succeed to and become vested with all of the rights, powers, privileges and duties of the retiring Letter of Credit Issuer; (ii) the retiring Letter of Credit Issuer shall be discharged from all of their respective duties and obligations hereunder or under the other Loan Documents; and (iii) the successor Letter of Credit Issuer shall issue letters of credit in substitution for the Letters of Credit, if any, outstanding at the time of such succession or make other arrangements satisfactory to the retiring Letter of Credit Issuer to effectively assume the obligations of the retiring Letter of Credit Issuer with respect to such Letters of Credit.

SECTION 7.7. NON-RELIANCE ON AGENT AND OTHER LENDERS. Each Lender acknowledges that it has, independently and without reliance upon Agent, any other Lender or any of their related parties and based on such documents and information as it has deemed appropriate, made its own credit analysis and decision to enter into this Agreement. Each Lender also acknowledges that it will, independently and without reliance upon Agent, any other Lender or any of their related parties and based on such documents and information as it shall from time to time deem appropriate, continue to make its own decisions in taking or not taking action under or based upon this Agreement, any other Loan Document or any related agreement or any document furnished hereunder or thereunder.

SECTION 7.8. NO OTHER DUTIES, ETC. Notwithstanding anything to the contrary contained herein, no person identified herein or on the facing page or signature pages hereof as a "Syndication Agent," "Documentation Agent," "Co-Agent," "Book Manager," "Book Runner," "Arranger," "Lead Arranger," "Co-Lead Arranger" or "Co-Arranger," if any, shall have or be deemed to have any right, power, obligation, liability, responsibility or duty under this Agreement or the other Loan Documents, other than in such person's capacity as: (a) Agent, a Lender, issuer of Letters of Credit hereunder; and (b) an Indemnitee hereunder.

As used herein, the term "Indemnitee" means, collectively, Agent (and any sub-agent thereof), each Lender, Letter of Credit Issuer and each related party of any of the foregoing persons.

SECTION 7.9. AGENT MAY FILE PROOFS OF CLAIM. In case of the pendency of any receivership, insolvency, liquidation, bankruptcy, reorganization, arrangement, adjustment, composition or other judicial proceeding relative to Borrower, Agent (irrespective of whether the principal of any amount under the Line of Credit or any Letter of Credit shall then be due and payable as herein expressed or by declaration or otherwise and irrespective of whether Agent shall have made any demand on Borrower) shall be entitled

and empowered, by intervention in such proceeding or otherwise: (a) to file and prove a claim for the whole amount of the principal and interest owing and unpaid in respect of the Line of Credit and any Letter of Credit and all other obligations that are owing and unpaid and to file such other documents as may be necessary or advisable in order to have the claims of Lenders and Agent (including any claim for the reasonable compensation, expenses, disbursements and advances of Lenders and Agent and their respective agents and counsel and all other amounts due Lenders and Agent under **Section 1.3** and **Section 8.3**) allowed in such judicial proceeding; and (b) to collect and receive any monies or other property payable or deliverable on any such claims and to distribute the same; and any custodian, receiver, assignee, trustee, liquidator, sequestrator or other similar official in any such judicial proceeding is hereby authorized by each Lender to make such payments to Agent and, in the event that Agent shall consent to the making of such payments directly to Lenders, to pay to Agent any amount due for the reasonable compensation, expenses, disbursements and advances of Agent and its agents and counsel, and any other amounts due Agent under **Section 1.3** and **Section 8.3** . Nothing contained herein shall be deemed to authorize Agent to authorize or consent to or accept or adopt on behalf of any Lender any plan of reorganization, arrangement, adjustment or composition affecting the obligations or the rights of any Lender or to authorize Agent to vote in respect of the claim of any Lender in any such proceeding.

ARTICLE VIII
MISCELLANEOUS

SECTION 8.1. NO WAIVER. No delay, failure or discontinuance of Agent or Lenders in exercising any right, power or remedy under any of the Loan Documents shall affect or operate as a waiver of such right, power or remedy; nor shall any single or partial exercise of any such right, power or remedy preclude, waive or otherwise affect any other or further exercise thereof or the exercise of any other right, power or remedy. Any waiver, permit, consent or approval of any kind by Lenders of any breach of or default under any of the Loan Documents must be in writing and shall be effective only to the extent set forth in such writing.

SECTION 8.2. NOTICES. All notices, requests and demands which any party is required or may desire to give to any other party under any provision of this Agreement must be in writing delivered to each party at the following address:

BORROWER: POWER INTEGRATIONS, INC.
5245 Hellyer Avenue
San Jose, CA 95138

AGENT: WELLS FARGO BANK, NATIONAL ASSOCIATION
Santa Clara Technology Regional Commercial Banking Office
121 S. Market Street, 2nd Floor
San Jose, CA 95113

LENDERS: As set forth on Schedule 1

or to such other address as any party may designate by written notice to all other parties. Each such notice, request and demand shall be deemed given or made as follows: (a) if sent by hand delivery, upon delivery; (b) if sent by mail, upon the earlier of the date of receipt or three (3) days after deposit in the U.S. mail, first class and postage prepaid; and (c) if sent by telecopy, upon receipt.

SECTION 8.3. COSTS, EXPENSES AND ATTORNEYS' FEES. Borrower shall pay to Agent and Lenders immediately upon demand the full amount of all payments, advances, charges, costs and expenses, including reasonable attorneys' fees (to include outside counsel fees and all allocated costs of Agent's and/or any Lender's in-house counsel), expended or incurred by Agent or any Lender in connection with (a) the negotiation and preparation of this Agreement and the other Loan Documents, Agent's continued

administration hereof and thereof, and the preparation of any amendments and waivers hereto and thereto, (b) the enforcement of Agent and Lenders' rights and/or the collection of any amounts which become due to Agent or any Lender under any of the Loan Documents, and (c) the prosecution or defense of any action in any way related to any of the Loan Documents, including without limitation, any action for declaratory relief, whether incurred at the trial or appellate level, in an arbitration proceeding or otherwise, and including any of the foregoing incurred in connection with any bankruptcy proceeding (including without limitation, any adversary proceeding, contested matter or motion brought by Agent or any Lender or any other person) relating to Borrower or any other person or entity.

SECTION 8.4. SUCCESSORS, ASSIGNMENT.

(a) Successors and Assigns Generally . The provisions of this Agreement shall be binding upon and inure to the benefit of the parties hereto and their respective successors and assigns permitted hereby, except that Borrower may not assign or otherwise transfer any of its rights or obligations hereunder without the prior written consent of Agent, each Lender and Letter of Credit Issuer, and no Lender may assign or otherwise transfer any of its rights or obligations hereunder except: (i) to an Eligible Assignee in accordance with the provisions of subsection (b) of this **Section 8.4** ; (ii) by way of participation in accordance with the provisions of subsection (d) of this **Section 8.4** ; or (iii) by way of pledge or assignment of a security interest subject to the restrictions of subsection (f) of this **Section 8.4**; and any other attempted assignment or transfer by any party hereto shall be null and void. Nothing in this Agreement, expressed or implied, shall be construed to confer upon any person (other than the parties hereto, their respective successors and assigns permitted hereby, Participants to the extent provided in subsection (d) of this **Section 8.4** and, to the extent expressly contemplated hereby, the related parties of each of Agent, each Lender and Letter of Credit Issuer) any legal or equitable right, remedy or claim under or by reason of this Agreement.

(b) Assignments by any Lender . Any Lender may at any time assign to one or more assignees all or a portion of its rights and obligations under this Agreement (including all or a portion of its Commitment(s) and the Line of Credit Advances (including for purposes of this subsection (b), participations in Letter of Credit Obligations) at the time owing to it); *provided* that any such assignment shall be subject to the following conditions:

(i) Minimum Amounts .

(A) in the case of an assignment of the entire remaining amount of the assigning Lender's Commitment(s) and the Line of Credit Advances at the time owing to it, no minimum amount need be assigned;

(B) in any case not described in the immediately preceding subclause (A), the aggregate amount of any Commitment (which, for this purpose, includes the Outstanding Amount of all Line of Credit Advances hereunder with respect thereto) or, if the applicable Commitment is not then in effect, the Outstanding Amount of the Line of Credit Advances of the assigning Lender subject to each such assignment (determined as of the date the assignment and assumption with respect to such assignment is delivered to Agent or, if "Trade Date" is specified in such assignment and assumption, as of such "Trade Date") shall not be less than \$10,000,000.00, unless (I) Agent consents (which consent shall not be unreasonably withheld or delayed) and (II) so long as an Event of Default has not occurred and is continuing), Borrower consents (which consent shall not be unreasonably withheld); *provided* that Borrower shall be deemed to have consented to any such amount unless it shall have objected thereto by written notice to Agent within five (5) Business Days following the date it receives notice of such proposed assignment.

(ii) Proportionate Amounts . Each partial assignment shall be made as an assignment of a proportionate part of all of the assigning Lender's rights and obligations under this Agreement with respect to the Line of Credit Advances or Commitments assigned.

(iii) *Required Consents* . No consent shall be required for any assignment other than:

(A) any consent required by required by **Section 8.4(b)(i)(B)** ;

(B) the consent of Borrower (which consent shall not be unreasonably withheld); *provided* that no consent of Borrower shall be required under this **Section 8.4(b)(iii)(B)** if (I) an Event of Default has occurred and is continuing or (II) such assignment is to an Eligible Assignee; *provided further* that Borrower shall be deemed to have consented to any such assignment unless it shall have objected thereto by written notice to Agent within five (5) Business Days following the date it received notice of such proposed assignment;

(C) the consent of Agent (which consent shall not be unreasonably withheld or delayed) if such assignment is: (I) an assignment of a Commitment to a person (irrespective of whether such person is an Eligible Assignee) who does not then have a Commitment; or (II) an assignment of Line of Credit Advances to a person that is not an Eligible Assignee; and

(D) the consent of Letter of Credit Issuer (which consent shall not be unreasonably withheld or delayed) if such assignment increases the obligation of the assignee to participate in exposure under one or more Letters of Credit (whether or not then outstanding).

(iv) *Assignment and Assumption* . The parties to each assignment shall execute and deliver to Agent an assignment and assumption, together with a processing and recordation fee in the amount of \$3,500.00; *provided* that Agent: (A) waives such processing and recordation fee in connection with any assignment effected pursuant to **Section 1.10(a)** ; and (B) may, in its sole discretion, elect to waive such processing and recordation fee in the case of any other assignment. The assignee, if it is not a Lender, shall deliver to Agent such administrative details as Agent may request in order to carry out its duties as Agent.

(v) *No Assignment to Borrower* . No such assignment shall be made to Borrower or any of its Affiliates or Subsidiaries.

(vi) *No Assignment to Natural Persons*. No such assignment shall be made to a natural person.

Subject to acceptance and recording thereof by Agent pursuant to subsection (c) of this **Section 8.4** , from and after the effective date specified in each assignment and assumption, the assignee thereunder shall be a party to this Agreement and, to the extent of the interest assigned by such assignment and assumption, have the rights and obligations of the assigning Lender under this Agreement, and the assigning Lender thereunder shall, to the extent of the interest assigned by such assignment and assumption, be released from its obligations under this Agreement (and, in the case of an assignment and assumption covering all of the assigning Lender's rights and obligations under this Agreement, such Lender shall cease to be a party hereto) but shall continue to be entitled to the benefits of **Section 1.11** and **Section 8.3** with respect to facts and circumstances occurring prior to the effective date of such assignment. Upon request, Borrower (at its expense) shall execute and deliver notes to the assignee Lender. Any assignment or transfer by a Lender of rights or obligations under this Agreement that does not comply with this subsection shall be treated for purposes of this Agreement as a sale by such Lending Party of a participation in such rights and obligations in accordance with subsection (d) of this **Section 8.4** .

(c) Register . Agent, acting solely for this purpose as an agent of Borrower, shall maintain at Agent's Office a copy of each assignment and assumption delivered to it and a register of Lenders and Letter of Credit Issuer. The entries in such register shall be conclusive, and Borrower, Agent, Lenders and

Letter of Credit Issuer may treat each person whose name is recorded in such register pursuant to the terms hereof as a Lender hereunder for all purposes of this Agreement, notwithstanding notice to the contrary. Such register shall be available for inspection by each of Borrower and Letter of Credit Issuer, at any reasonable time and from time to time upon reasonable prior notice. In addition, at any time that a request for a consent for a material or substantive change to the Loan Documents is pending, any Lender wishing to consult with other Lenders in connection therewith may request and receive from Agent a copy of such register.

(d) Participations. Any Lender may at any time, without the consent of, or notice to, Borrower or Agent, sell participations to any Participant in all or a portion of such person's rights and/or obligations under this Agreement (including all or a portion of its Commitment(s) and/or the Line of Credit Advances (including such Lender's participations in Letter of Credit Obligations) owing to it); *provided* that: (i) such person's obligations under this Agreement shall remain unchanged; (ii) such person shall remain solely responsible to the other parties hereto for the performance of such obligations; (iii) Borrower, Agent, Lenders and Letter of Credit Issuer shall continue to deal solely and directly with such person in connection with such person's rights and obligations under this Agreement; and (iv) the amount of such participation shall not be less than \$10,000,000.00 (or the Outstanding Amount of any Line of Credit Advances). Any document pursuant to which a Lender sells such a participation shall provide that such person shall retain the sole right to enforce this Agreement and the other Loan Documents and to approve any amendment, modification or waiver of any provision of this Agreement and the other Loan Documents; *provided* that such document may provide that such person will not, without the consent of the Participant, agree to any amendment, waiver or other modification described in the first proviso to **Section 8.5** that affects such Participant. Subject to subsection (e) of this **Section 8.4**, Borrower agrees that each Participant shall be entitled to the benefits of **Section 1.12** to the same extent as if it were a Lender hereunder and had acquired its interest by assignment pursuant to subsection (b) of this **Section 8.4**. To the extent permitted by law, each Participant also shall be entitled to the benefits of any right of setoff hereunder as though it were a Lender Party, as long as such Participant agrees to be subject to **Section 1.8** as though it were a Lender.

(e) Limitation upon Participant Rights. A Participant shall not be entitled to receive any greater payment under **Section 1.12** than the applicable Lender would have been entitled to receive with respect to the participation sold to such Participant, unless the sale of the participation to such Participant is made with Borrower's prior written consent.

(f) Certain Pledges. Any Lender may at any time pledge or assign a security interest in all or any portion of its rights under this Agreement (including under its note, if any) to secure obligations of such Lender owing to a Federal Reserve Bank; *provided* that no such pledge or assignment shall release such Lender from any of its obligations hereunder or substitute any such pledgee or assignee for such Lender as a party hereto.

(g) Electronic Execution of Assignments. The words "execution," "signed," "signature," and words of like import in any assignment and assumption shall be deemed to include electronic signatures or the keeping of records in electronic form, each of which shall be of the same legal effect, validity or enforceability as a manually executed signature or the use of a paper-based recordkeeping system, as the case may be, to the extent and as provided for in any applicable Laws, including the Federal Electronic Signatures in Global and National Commerce Act, the California Uniform Electronic Transactions Act or any other similar state laws based on the Uniform Electronic Transactions Act.

(h) Resignation as Letter of Credit Issuer. Notwithstanding anything to the contrary contained herein, if at any time Wells Fargo assigns all of its Commitments and Loans pursuant to subsection (b) of this **Section 8.4**, Wells Fargo may upon thirty (30) days' notice to Borrower and all Lenders, resign as Letter of Credit Issuer. In the event of any such resignation as Letter of Credit Issuer, Borrower shall be entitled to appoint from among Lenders a successor Letter of Credit Issuer; *provided* that no failure by Borrower to appoint any such successor shall affect the resignation of Wells Fargo as Letter of Credit Issuer. If Wells Fargo resigns as Letter of Credit Issuer, it shall retain all the rights and obligations of Letter of Credit Issuer

hereunder with respect to all Letters of Credit outstanding as of the effective date of its resignation as Letter of Credit Issuer and all Letter of Credit Obligations with respect thereto (including the right to require Lenders to make Line of Credit Advances that are Prime Rate Loans or fund risk participations in Unreimbursed Amounts pursuant to **Section 1.2(c)**).

SECTION 8.5. AMENDMENTS, ETC. No amendment or waiver of any provision of this Agreement or any other Loan Document, and no consent to any departure by Borrower or any subsidiary thereof therefrom, shall be effective unless in writing signed by Required Lenders (or Agent at the written request of Required Lenders) and Borrower as the case may be, with receipt acknowledged by Agent, and each such waiver or consent shall be effective only in the specific instance and for the specific purpose for which given; *provided* that no such amendment, waiver or consent shall:

(a) Matters Involving Certain Lenders .

(i) postpone or delay any date fixed by this Agreement or any other Loan Document for any payment of principal, interest, fees or other amounts due to any Lender hereunder or under any other Loan Document, or reduce the amount due to any Lender on any such date, in each case without the written consent of such Lender; or

(ii) reduce the principal of, or the rate of interest or commitment fee specified herein on, any Line of Credit Advance or any Commitment or other amounts payable to any Lender hereunder or under any other Loan Document, in each case without the written consent of such Lender; or

(iii) increase, extend the expiry of, or reinstate, the Commitment of any Lender without the written consent of such Lender;

(b) Matters Involving All Lenders . Unless in writing and signed by all Lenders with receipt acknowledged by Agent, do any of the following:

(i) increase or extend the Commitments or the Letter of Credit Sublimit (or reinstate any such Commitment or the Letter of Credit Sublimit to the extent terminated pursuant to **Section 6.2**) without the consent of each Lender; or

(ii) amend any provision herein providing for consent or other action by all Lenders; or

(iii) amend the definition of “ Required Lenders ”; or

(iv) amend this **Section 8.5** ; or

(v) release all or any portion of any collateral securing the obligations of Borrower under this Agreement and the other Loan Documents; or

(vi) release or terminate any guaranty in favor of Agent guaranteeing the payment or performance of any obligations under this Agreement or any other Loan Document; or

(vii) amend the definition of “ Maturity Date ”;

(c) Matters Involving Required Lenders . No such waiver, amendment or consent to any representation, warranty, covenant, Event of Default or other provision of any Loan Document shall be effective for purposes of **Section 3.2** with respect to the making of Line of Credit Advances or the issuance of any Letter of Credit, the extension of the expiry date of any Letter of Credit or the increase of the amount of any Letter of Credit after the Closing Date unless in writing and signed by Required Lenders and Borrower, with receipt acknowledged by Agent;

provided further that: (i) no amendment, waiver or consent shall, unless in writing and signed by Letter of

Credit Issuer in addition to such Lenders as are otherwise required by this **Section 8.5** , affect the rights or duties of Letter of Credit Issuer under this Agreement or any related document relating to any Letter of Credit issued or to be issued by it; and (ii) no amendment, waiver or consent shall, unless in writing and signed by Agent in addition to such Lenders as are otherwise required by this **Section 8.5** , affect the rights or duties of Agent under this Agreement or any other Loan Document. Notwithstanding anything to the contrary herein, no Lender who is at the time a Defaulting Lender shall have any right to approve or disapprove any amendment, waiver or consent hereunder, except that the Commitment of such Lender may not be increased or extended without the consent of such Lender.

SECTION 8.6. ENTIRE AGREEMENT. This Agreement and the other Loan Documents constitute the entire agreement between the parties hereto with respect to each credit subject hereto and supersede all prior negotiations, communications, discussions and correspondence concerning the subject matter hereof.

SECTION 8.7. NO THIRD PARTY BENEFICIARIES. This Agreement is made and entered into for the sole protection and benefit of the parties hereto and their respective permitted successors and assigns, and no other person or entity shall be a third party beneficiary of, or have any direct or indirect cause of action or claim in connection with, this Agreement or any other of the Loan Documents to which it is not a party.

SECTION 8.8. TIME. Time is of the essence of each and every provision of this Agreement and each other of the Loan Documents.

SECTION 8.9. SEVERABILITY OF PROVISIONS. If any provision of this Agreement shall be prohibited by or invalid under applicable law, such provision shall be ineffective only to the extent of such prohibition or invalidity without invalidating the remainder of such provision or any remaining provisions of this Agreement.

SECTION 8.10. COUNTERPARTS. This Agreement may be executed in any number of counterparts, each of which when executed and delivered shall be deemed to be an original, and all of which when taken together shall constitute one and the same Agreement.

SECTION 8.11. GOVERNING LAW. This Agreement shall be governed by and construed in accordance with the laws of the State of California.

SECTION 8.12. ARBITRATION.

(a) Arbitration. The parties hereto agree, upon demand by any party, to submit to binding arbitration all claims, disputes and controversies between or among them (and their respective employees, officers, directors, attorneys, and other agents), whether in tort, contract or otherwise in any way arising out of or relating to (i) any credit subject hereto, or any of the Loan Documents, and their negotiation, execution, collateralization, administration, repayment, modification, extension, substitution, formation, inducement, enforcement, default or termination; or (ii) requests for additional credit.

(b) Governing Rules. Any arbitration proceeding will (i) proceed in a location in California selected by the American Arbitration Association (“AAA”); (ii) be governed by the Federal Arbitration Act (Title 9 of the United States Code), notwithstanding any conflicting choice of law provision in any of the documents between the parties; and (iii) be conducted by the AAA, or such other administrator as the parties shall mutually agree upon, in accordance with the AAA's commercial dispute resolution procedures, unless the claim or counterclaim is at least \$1,000,000.00 exclusive of claimed interest, arbitration fees and costs in which case the arbitration shall be conducted in accordance with the AAA's optional procedures for large, complex commercial disputes (the commercial dispute resolution procedures or the optional procedures for large, complex commercial disputes to be referred to herein, as applicable, as the “Rules”). If there is any inconsistency between the terms hereof and the Rules, the terms and procedures set forth herein shall

control. Any party who fails or refuses to submit to arbitration following a demand by any other party shall bear all costs and expenses incurred by such other party in compelling arbitration of any dispute. Nothing contained herein shall be deemed to be a waiver by any party that is a bank of the protections afforded to it under 12 U.S.C. §91 or any similar applicable state law.

(c) No Waiver of Provisional Remedies, Self-Help and Foreclosure. The arbitration requirement does not limit the right of any party to (i) foreclose against real or personal property collateral; (ii) exercise self-help remedies relating to collateral or proceeds of collateral such as setoff or repossession; or (iii) obtain provisional or ancillary remedies such as replevin, injunctive relief, attachment or the appointment of a receiver, before during or after the pendency of any arbitration proceeding. This exclusion does not constitute a waiver of the right or obligation of any party to submit any dispute to arbitration or reference hereunder, including those arising from the exercise of the actions detailed in sections (i), (ii) and (iii) of this paragraph.

(d) Arbitrator Qualifications and Powers. Any arbitration proceeding in which the amount in controversy is \$5,000,000.00 or less will be decided by a single arbitrator selected according to the Rules, and who shall not render an award of greater than \$5,000,000.00. Any dispute in which the amount in controversy exceeds \$5,000,000.00 shall be decided by majority vote of a panel of three arbitrators; *provided* however, that all three arbitrators must actively participate in all hearings and deliberations. The arbitrator will be a neutral attorney licensed in the State of California or a neutral retired judge of the state or federal judiciary of California, in either case with a minimum of ten years experience in the substantive law applicable to the subject matter of the dispute to be arbitrated. The arbitrator will determine whether or not an issue is arbitratable and will give effect to the statutes of limitation in determining any claim. In any arbitration proceeding the arbitrator will decide (by documents only or with a hearing at the arbitrator's discretion) any pre-hearing motions which are similar to motions to dismiss for failure to state a claim or motions for summary adjudication. The arbitrator shall resolve all disputes in accordance with the substantive law of California and may grant any remedy or relief that a court of such state could order or grant within the scope hereof and such ancillary relief as is necessary to make effective any award. The arbitrator shall also have the power to award recovery of all costs and fees, to impose sanctions and to take such other action as the arbitrator deems necessary to the same extent a judge could pursuant to the Federal Rules of Civil Procedure, the California Rules of Civil Procedure or other applicable law. Judgment upon the award rendered by the arbitrator may be entered in any court having jurisdiction. The institution and maintenance of an action for judicial relief or pursuit of a provisional or ancillary remedy shall not constitute a waiver of the right of any party, including the plaintiff, to submit the controversy or claim to arbitration if any other party contests such action for judicial relief.

(e) Discovery. In any arbitration proceeding, discovery will be permitted in accordance with the Rules. All discovery shall be expressly limited to matters directly relevant to the dispute being arbitrated and must be completed no later than 20 days before the hearing date. Any requests for an extension of the discovery periods, or any discovery disputes, will be subject to final determination by the arbitrator upon a showing that the request for discovery is essential for the party's presentation and that no alternative means for obtaining information is available.

(f) Class Proceedings and Consolidations. No party hereto shall be entitled to join or consolidate disputes by or against others in any arbitration, except parties who have executed any Loan Document, or to include in any arbitration any dispute as a representative or member of a class, or to act in any arbitration in the interest of the general public or in a private attorney general capacity.

(g) Payment Of Arbitration Costs And Fees. The arbitrator shall award all costs and expenses of the arbitration proceeding.

(h) Real Property Collateral; Judicial Reference. Notwithstanding anything herein to the contrary, no dispute shall be submitted to arbitration if the dispute concerns indebtedness secured directly or indirectly, in whole or in part, by any real property unless (i) the holder of the mortgage, lien or security interest

specifically elects in writing to proceed with the arbitration, or (ii) all parties to the arbitration waive any rights or benefits that might accrue to them by virtue of the single action rule statute of California, thereby agreeing that all indebtedness and obligations of the parties, and all mortgages, liens and security interests securing such indebtedness and obligations, shall remain fully valid and enforceable. If any such dispute is not submitted to arbitration, the dispute shall be referred to a referee in accordance with California Code of Civil Procedure Section 638 et seq., and this general reference agreement is intended to be specifically enforceable in accordance with said Section 638. A referee with the qualifications required herein for arbitrators shall be selected pursuant to the AAA's selection procedures. Judgment upon the decision rendered by a referee shall be entered in the court in which such proceeding was commenced in accordance with California Code of Civil Procedure Sections 644 and 645.

(i) Miscellaneous. To the maximum extent practicable, the AAA, the arbitrators and the parties shall take all action required to conclude any arbitration proceeding within 180 days of the filing of the dispute with the AAA. No arbitrator or other party to an arbitration proceeding may disclose the existence, content or results thereof, except for disclosures of information by a party required in the ordinary course of its business or by applicable law or regulation. If more than one agreement for arbitration by or between the parties potentially applies to a dispute, the arbitration provision most directly related to the Loan Documents or the subject matter of the dispute shall control. This arbitration provision shall survive termination, amendment or expiration of any of the Loan Documents or any relationship between the parties.

(j) Small Claims Court. Notwithstanding anything herein to the contrary, each party retains the right to pursue in Small Claims Court any dispute within that court's jurisdiction. Further, this arbitration provision shall apply only to disputes in which either party seeks to recover an amount of money (excluding attorneys' fees and costs) that exceeds the jurisdictional limit of the Small Claims Court.

SECTION 8.13. USA PATRIOT ACT NOTICE. Each Lender that is subject to the Patriot Act and Agent (for itself and not on behalf of any Lender) hereby notifies Borrower that, pursuant to the requirements of the Patriot Act, they are required to obtain, verify and record information that identifies Borrower, which information includes the name and address of Borrower and other information that will allow such Lender or Agent, as applicable to identify Borrower in accordance with the Patriot Act.

As used herein, the term "Patriot Act" means the USA Patriot Act (Title III of Pub. L. 107-56 (signed into law October 26, 2001)).

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the day and year first written above.

BORROWER:

POWER INTEGRATIONS, INC.

By: /s/ Balu Balakrishnan
Balu Balakrishnan,
President & CEO

AGENT:

WELLS FARGO BANK,
NATIONAL ASSOCIATION

By: /s/ Greg P. Cohn
Greg P. Cohn,
Senior Vice President

LENDERS:

WELLS FARGO BANK,
NATIONAL ASSOCIATION

By: /s/ Greg P. Cohn
Greg P. Cohn,
Senior Vice President

UNION BANK, N.A.

By: /s/ Michael J. McCutchin
Michael J. McCutchin,
Vice President

LETTER OF CREDIT ISSUER:

WELLS FARGO BANK,
NATIONAL ASSOCIATION

By: /s/ Greg P. Cohn
Greg P. Cohn,
Senior Vice President

Schedule 1 to Credit Agreement

Lender	Address	Commitment	Pro Rata Share
Wells Fargo Bank, National Association	Santa Clara Technology Regional Commercial Banking Office 121 S. Market Street, 2 nd Floor San Jose, CA 95113	\$65,000,000.00	65%
Union Bank, N.A.	San Jose Regional Office 99 Almaden Boulevard, Suite 200 MC 1-645 San Jose, CA 95113	\$35,000,000.00	35%
Total:		\$100,000,000.00	100%

Schedule 2 to Credit Agreement

Existing Letters of Credit

Beneficiary	Number	Issue Date	Expiry Date	Letter of Credit Issue Amount
SS SC IP Holdings, LLC c/o Southern Farm Bureau Life Insurance Attn: Chief Investment Officer 1401 Livingston Rd. Jackson, Mississippi 39213	IS0002369	August 11, 2011	August 19, 2012	\$15,000,000

Exhibit A to Credit Agreement

LIBOR Early Termination Prepayment Example

Amount of LIBOR Rate Loans:	\$1,000,000.00	
Initial Date:	February 1, 2013	
Fixed Rate Term:	90 days	to May 1, 2013
Initial Rate (for illustrative purposes only):	0.45%	
Termination Date:	April 1, 2013	April 1, 2013
Days Remaining:	30 days	30 days
LIBOR at Termination Date for Days Remaining (30-day LIBOR):	0.3%	0.5%

Two Examples - one rate higher and one rate lower at the time of termination

Prepayment Calculation	Rate Lower	Rate Higher
Interest over remaining 30 days if no termination:	375	375
Interest over remaining 30 days at new LIBOR Rate at Termination Date (i.e., 0.30% and 0.50% with 30 days remaining):	250	417
Difference in interest over remaining days in term:	125	(42)
Prepayment that would apply:	125	none

LINE OF CREDIT NOTE

\$65,000,000.00

San Jose, California

July 5, 2012

FOR VALUE RECEIVED, the undersigned POWER INTEGRATIONS, INC. ("Borrower") promises to pay to the order of WELLS FARGO BANK, NATIONAL ASSOCIATION ("Wells Fargo") at the Agent's Office described in the Credit Agreement, or at such other place as the holder hereof may designate, in lawful money of the United States of America and in immediately available funds, the principal amount of Sixty-Five Million Dollars (\$65,000,000.00), or so much thereof as may be advanced and be outstanding, with interest thereon, to be computed on each advance from the date of its disbursement, whether before or after any breach hereof at the rate(s) per annum and on the terms set forth in the Credit Agreement, dated as of July 5, 2012, among Borrower, Union Bank, N.A. ("Union"), Wells Fargo, each other financial institution listed on Schedule 1 thereto (collectively, including Wells Fargo in its capacity as a lender thereunder, the "Lenders"), and Wells Fargo as administrative agent for the Lenders (in such capacity, "Agent"), as amended, restated, modified and/or supplemented from time to time (the "Credit Agreement").

Borrower promises to pay interest on the unpaid principal amount of each Line of Credit Advance as provided in the Credit Agreement. If any amount is not paid in full when due hereunder, such unpaid amount shall bear interest, to be paid upon demand, from the due date thereof until the date of actual payment (and before as well as after judgment) as set forth in the Credit Agreement.

This Note is one of the notes made pursuant to the Credit Agreement. All terms defined in the Credit Agreement shall have the same meaning when used herein, and the rates of interest applicable hereto shall change from time to time in accordance with the terms of the Credit Agreement.

The unpaid principal balance of this Note at any time shall be the total of all amounts advanced hereunder by the holder hereof less the amount of all principal payments made hereon by or for Borrower, which balance may be endorsed hereon from time to time by the holder. The outstanding principal balance of this Note, together with any accrued and unpaid interest thereon, shall be due and payable in full on July 5, 2015. Borrower may prepay principal on this Note solely in accordance with the terms of the Credit Agreement.

Upon the occurrence and continuation of one or more of the Events of Default specified in the Credit Agreement, all amounts then remaining unpaid on this Note shall become, or may be declared to be, immediately due and payable all as provided in the Credit Agreement. Line of Credit Advances made by the holder of this Note shall be evidenced by one or more loan accounts or records maintained by the holder of this Note in the ordinary course of business. Lender may also attach schedules to this Note and endorse thereon the date, amount and maturity of its Line of Credit Advances and payments with respect thereto.

Borrower, for itself, its successors and assigns, hereby waives diligence, presentment, protest and demand and notice of protest, demand, dishonor and non-payment of this Note.

This Note shall be governed by and construed in accordance with the laws of the State of California, except to the extent the holder of this Note has greater rights or remedies under Federal law, whether as a national bank or otherwise, in which case such choice of California law shall not be deemed to deprive the holder of this Note of such rights and remedies as may be available under Federal law.

[Signature follows on next page.]

IN WITNESS WHEREOF, the undersigned has caused this promissory note to be duly executed as of the day and year first written above.

POWER INTEGRATIONS, INC.,
a Delaware corporation

By: /s/ Balu Balakrishnan
Name: Balu Balakrishnan,
Title: President & CEO

LINE OF CREDIT NOTE

\$35,000,000.00

San Jose, California
July 5, 2012

FOR VALUE RECEIVED, the undersigned POWER INTEGRATIONS, INC. ("Borrower") promises to pay to the order of UNION BANK, N.A. ("Union") at the Agent's Office described in the Credit Agreement, or at such other place as the holder hereof may designate, in lawful money of the United States of America and in immediately available funds, the principal amount of Thirty-Five Million Dollars (\$35,000,000.00), or so much thereof as may be advanced and be outstanding, with interest thereon, to be computed on each advance from the date of its disbursement, whether before or after any breach hereof at the rate(s) per annum and on the terms set forth in the Credit Agreement, dated as of July 5, 2012, among Borrower, Union, Wells Fargo Bank, National Association ("Wells Fargo"), each other financial institution listed on Schedule 1 thereto (collectively, including Wells Fargo in its capacity as a lender thereunder, the "Lenders"), and Wells Fargo as administrative agent for the Lenders (in such capacity, "Agent"), as amended, restated, modified and/or supplemented from time to time (the "Credit Agreement").

Borrower promises to pay interest on the unpaid principal amount of each Line of Credit Advance as provided in the Credit Agreement. If any amount is not paid in full when due hereunder, such unpaid amount shall bear interest, to be paid upon demand, from the due date thereof until the date of actual payment (and before as well as after judgment) as set forth in the Credit Agreement.

This Note is one of the notes made pursuant to the Credit Agreement. All terms defined in the Credit Agreement shall have the same meaning when used herein, and the rates of interest applicable hereto shall change from time to time in accordance with the terms of the Credit Agreement.

The unpaid principal balance of this Note at any time shall be the total of all amounts advanced hereunder by the holder hereof less the amount of all principal payments made hereon by or for Borrower, which balance may be endorsed hereon from time to time by the holder. The outstanding principal balance of this Note, together with any accrued and unpaid interest thereon, shall be due and payable in full on July 5, 2015. Borrower may prepay principal on this Note solely in accordance with the terms of the Credit Agreement.

Upon the occurrence and continuation of one or more of the Events of Default specified in the Credit Agreement, all amounts then remaining unpaid on this Note shall become, or may be declared to be, immediately due and payable all as provided in the Credit Agreement. Line of Credit Advances made by the holder of this Note shall be evidenced by one or more loan accounts or records maintained by the holder of this Note in the ordinary course of business. Lender may also attach schedules to this Note and endorse thereon the date, amount and maturity of its Line of Credit Advances and payments with respect thereto.

Borrower, for itself, its successors and assigns, hereby waives diligence, presentment, protest and demand and notice of protest, demand, dishonor and non-payment of this Note.

This Note shall be governed by and construed in accordance with the laws of the State of California, except to the extent the holder of this Note has greater rights or remedies under Federal law, whether as a national bank or otherwise, in which case such choice of California law shall not be deemed to deprive the holder of this Note of such rights and remedies as may be available under Federal law.

[Signature follows on next page.]

IN WITNESS WHEREOF, the undersigned has caused this promissory note to be duly executed as of the day and year first written above.

POWER INTEGRATIONS, INC.,
a Delaware corporation

By: /s/ Balu Balakrishnan

Name: Balu Balakrishnan,

Title: President & CEO

Description of Directors Equity Compensation Program

Initial and annual grants will be made to outside directors primarily under the Power Integrations 2007 Equity Incentive Plan (the “*2007 Plan*”) as follows (the “*Directors Equity Compensation Program*”):

1. Each current participant and each individual who would be eligible to participate in the 1997 Outside Directors Stock Option Plan shall be a participant in the Directors Equity Compensation Program;
2. On the first trading day of July in each year (the “Regular Grant Date”):
 - Each outside director will receive a grant of an equity award with an aggregate value of \$100,000 (the “*Award*”).
 - At each outside director's election, such Award would consist entirely of RSUs or entirely of options.
 - If applicable, the number of options issuable under such Award would be calculated as the dollar value of such Award allocated to options divided by the Black-Scholes value of one option share as of the grant date (and the exercise price of such option would equal the closing trading price of the Company's common stock on such grant date).
 - If applicable, the number of RSUs issuable under such Award would be calculated as the dollar value of such Award allocated to RSUs divided by the closing trading price of the Company's common stock on such grant date.
 - Each such Award would vest in full effective immediately prior to the commencement of the Company's first annual meeting of stockholders in the year following the year of the grant date, provided that the recipient is still providing services to the Company as a director as of such time, and, provided, further, that 100% of the shares subject to such Award would be deemed fully vested upon the occurrence of a Change of Control, as such term is defined in the Company's 2007 Plan.
3. A new eligible director would receive under the 2007 Plan (or, if determined by the Committee, under the 1997 Outside Directors Stock Option Plan) an Award, which Award shall consist entirely of RSUs or entirely of options, at such new eligible director's election, and shall be equal to the pro rated portion of the Company's annual Awards based on the time between the date the new director is appointed to the Board and the first trading day of Nasdaq in the month of July following such director's appointment.
4. The Directors Equity Compensation Program shall remain in effect at the discretion of the Board or the Compensation Committee.

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, Balu Balakrishnan certify that:

1. I have reviewed this Form 10-Q of Power Integrations, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: October 30, 2012

By: /s/ BALU BALAKRISHNAN

Balu Balakrishnan
Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Sandeep Nayyar, certify that:

1. I have reviewed this Form 10-Q of Power Integrations, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: October 30, 2012

By: /s/ SANDEEP NAYYAR

Sandeep Nayyar
Chief Financial Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF
THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Power Integrations, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2012, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Balu Balakrishnan, Chief Executive Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), certify to the best of my knowledge that:

- (1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: October 30, 2012

By: /s/ BALU BALAKRISHNAN

Balu Balakrishnan
Chief Executive Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.

CERTIFICATION OF CHIEF FINANCIAL OFFICER

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF
THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of Power Integrations, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2012, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Sandeep Nayyar, Chief Financial Officer of the Company, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 ("Section 906"), certify to the best of my knowledge that:

- (1) The Report fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: October 30, 2012

By: /s/ SANDEEP NAYYAR

Sandeep Nayyar
Chief Financial Officer

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Registrant and will be retained by the Registrant and furnished to the Securities and Exchange Commission or its staff upon request.